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INVESTMENT TRUSTS AND INVESTMENT COMPANIES

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE
COMMITTEE ON BANKING AND CURRENCY
UNITED STATES SENATE

SEVENTY-SIXTH CONGRESS

THIRD SESSION

ON

S. 3580

A BILL TO PROVIDE FOR THE REGISTRATION AND REGULATION OF INVESTMENT COMPANIES AND INVESTMENT ADVISERS, AND FOR OTHER PURPOSES

PART 1

APRIL 2, 3, 4, 5, 8, 9, AND 10, 1940

Printed for the use of the Committee on Banking and Currency

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INVESTMENT TRUSTS AND INVESTMENT COMPANIES

TUESDAY, APRIL 2, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to call, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Maloney, Hughes, Miller, Downey, Townsend, and Taft.

Senator Wagner. The subcommittee will come to order. Senators Miller and Hughes have authorized the chairman to vote them for a quorum, and they will be here presently.

This subcommittee is called to begin hearings on S. 3580, introduced by the chairman, to provide for the registration and regulation of investment companies and investment advisers, and for other purposes. The full text of the bill will be made a part of the record at this point.

(S. 3580 is printed in full, as follows:)

[S. 3580, 76th Cong., 3d sess.]

A BILL To provide for the registration and regulation of investment companies and investment advisers, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I—INVESTMENT COMPANIES

FINDINGS

Section 1. Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby found that investment companies are affected with a national public interest in that, among other things—

(1) the securities issued by such companies, which constitute a substantial part of all securities publicly offered, are distributed, exchanged, transferred, redeemed, and repurchased by use of the mails and means and instrumentalities of interstate commerce, and in the case of the numerous companies which issue redeemable securities this process of distribution and redemption is continuous and constant;

(2) the principal activities of such companies—investing, reinvesting, and trading in securities issued by other companies—are conducted by use of the mails and means and instrumentalities of interstate commerce, including the facilities of national securities exchanges, and constitute a substantial part of all transactions effected in the securities markets of the Nation;

(3) such companies customarily invest and trade in securities issued by, and may dominate and control or otherwise affect the policies and management of, companies engaged in business in interstate commerce;

(4) such companies are media for the investment in the national economy of a substantial part of the national savings and may have a vital effect upon the flow of such savings into the capital markets; and

(5) the activities of such companies, extending over many States, and the wide geographic distribution of their security holders, make difficult, if not impossible, any effective State regulation of such companies in the interest of investors.

DECLARATION OF POLICY

Sec. 2. Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and responsibility of such companies and their management;

(2) when investment companies are organized, operated, or managed in the interest of directors, officers, managers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders and of the public;

(3) when investment companies issue securities containing inequitable, discriminatory, or anomalous provisions, or fail to protect the preferences and privileges of their outstanding securities;

(4) when the control or management of investment companies is unduly concentrated, inequitably distributed, or irresponsibly held;

(5) when investment companies, in keeping their accounts in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;

(6) when investment companies are reorganized, dissolved, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders and without adequate public supervision;

(7) when investment companies engage in manipulative or unduly speculative transactions, have excessive investments in securities or property of a speculative or unmarketable character, or by borrowing and the issuance of senior securities increase the speculative character of their junior securities; or

(8) when investment companies operate without adequate assets or reserves, or attain such great size as to preclude efficient investment management and to have excessive influence in the national economy.

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the abuses enumerated in this section.

DEFINITION OF INVESTMENT COMPANY

Sec. 3. (a) When used in this title, "investment company" means any issuer which—

(1) holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; or

(2) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

As used in this subsection, "investment securities" includes all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies.

(b) Notwithstanding paragraph (2) of subsection (a), none of the following issuers is an investment company within the meaning of this title:

(1) Any issuer primarily engaged, directly or through wholly-owned subsidiaries, in a business or businesses other than that of investing, reinvesting, or trading in securities.

(2) Any issuer which the Commission, upon application by such issuer, finds and by order declares to be primarily engaged, directly or through majority-owned subsidiaries, in a business or businesses other than that of investing, reinvesting, or trading in securities. The filing of an application under this paragraph by an issuer other than a registered investment company shall exempt the applicant from all provisions of this title for a period of sixty days. For cause shown the Commission by order may extend such period of exemption for an additional period or periods. Whenever the Commission, upon its own motion or upon application, finds that the circumstances which gave rise to the issuance of an order granting an application under this paragraph no longer exist, the Commission shall by order revoke such order.

(3) Any issuer all the outstanding securities of which (other than short-term paper) are directly or indirectly owned by a company excepted from the definition of investment company by paragraph (1) or (2) of this subsection.

(c) Notwithstanding subsections (a) and (b), none of the following persons is an investment company within the meaning of this title:

(1) Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not propose to make a public offering of its securities. For the purposes of this paragraph, beneficial ownership by a company shall be deemed to be beneficial ownership by one person; except that, if such company is an affiliated company of the issuer, the beneficial ownership shall be deemed to be that of the holders of such affiliated company's outstanding securities (other than short-term paper).

(2) Any person substantially all of whose gross income from securities and securities transactions is derived from acting as broker and from the distribution of securities issued by other persons.

(3) Any bank or insurance company; any common trust fund, as defined in section 169 of the Revenue Act of 1938; any savings and loan association substantially all the business of which is confined to the making of loans to members; or any person engaged exclusively in the business of making small loans and licensed under the laws of a State to engage in such business.

(4) Any company effectively registered as a holding company under the Public Utility Holding Company Act of 1935.

(5) Any company, other than a face-amount certificate company, substantially all the intangible assets of which consist of mortgages and other liens on real estate.

(6) Any person substantially all of whose business consists of owning or holding oil, gas, or other mineral royalties or leases, or fractional interests therein, or certificates of interest or participation in or investment contracts relative to such royalties, leases, or fractional interests.

(7) Any company organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(8) Any voting trust the assets of which consist exclusively of securities of a single issuer which is not an investment company.

(9) Any security holders' protective committee or similar issuer having outstanding and issuing no securities other than certificates of deposit and short-term paper.

CLASSIFICATION OF INVESTMENT COMPANIES

SEC. 4. For the purposes of this title, investment companies are divided into three principal classes, defined as follows:

(1) "Face-amount certificate company" means an investment company which is engaged in the business of issuing face-amount certificates, or which has been engaged in such business and has any such certificate outstanding.

(2) "Unit investment trust" means an investment company which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities; but does not include a voting trust, or any trust which issues and has outstanding no securities other than short-term paper and periodic payment plan certificates.

(3) "Management investment company" means any investment company other than a face-amount certificate company, a unit investment trust, or a company

which issues and has outstanding no securities other than short-term paper and periodic payment plan certificates.

SUBCLASSIFICATION OF MANAGEMENT INVESTMENT COMPANIES

SEC. 5. (a) For the purposes of this title, management investment companies are divided, according to the securities which they issue, into open-end and closed-end management investment companies, defined as follows:

(1) "Open-end management investment company" means a management investment company which is offering for sale or has outstanding any redeemable security of which it is the issuer.

(2) "Closed-end management investment company" means any management investment company other than an open-end management investment company.

(b) Management investment companies are further divided, according to the character of their assets, their investment policy and capital structure into diversified investment companies, securities trading companies, and securities finance companies, defined as follows:

(1) "Diversified investment company" means a management investment company which meets the following requirements:

(A) the value of its investment in the securities of any one issuer (other than Government securities) does not exceed 5 per centum of the value of its total assets;

(B) at least 85 per centum of the value of its total assets is represented by cash items, by Government securities, and by marketable securities of issuers of which it does not own more than 5 per centum of any class of securities outstanding;

(C) its portfolio turn-over during its last fiscal year did not exceed 150 per centum;

(D) it has outstanding only one class of securities other than short-term paper; and

(E) it does not control or own any voting security issued by any other investment company.

(2) "Securities trading company" means any management investment company other than a diversified investment company, which meets the requirements o subparagraphs (A) and (B) of paragraph (1).

(3) "Securities finance company" means any management investment company other than a diversified investment company or securities trading company.

(c) A registered diversified investment or securities trading company which at the time of its registration meets the requirements of subparagraphs (A) and (B) of paragraph (1) of subsection (b) shall not lose its status as a diversified investment or securities trading company because of any subsequent discrepancy between the value of its various investments and the requirements of said subparagraphs, so long as any such discrepancy existing immediately after its acquisition of any security or other property is neither wholly or partly the result of such acquisition.

(d) The Commission shall have authority, by rules and regulations in the public interest or for the protection of investors, to make further classifications and subclassifications of investment companies according to organization, capital structure, nature of assets, amount of assets, investment policy, character of business done, or any one or more other characteristics which the Commission deems significant and which are consistent with the definitions contained in this section and section 4.

EXEMPTIONS

SEC. 6. (a) The following investment companies are exempt from every provision of this title except section 7 (d):

(1) Any company not organized under the laws of the United States or of a State.

(2) Any company organized under the laws of and having its principal office and place of business in Alaska, Hawaii, Puerto Rico, the Philippine Islands, the Canal Zone, the Virgin Islands, or any other possession of the United States; but such exemption shall terminate if any security of which such company is the issuer is offered for sale or sold, after the effective date of this title, by such company or an underwriter therefor, to a resident of any State other than the State in which such company is organized.

(3) Any company for which, in a proceeding in any court of the United States or of a State, a receiver, trustee in bankruptcy, or similar officer had been appointed

or elected prior to the effective date of this title, and every such officer so appointed or elected prior to the effective date of this title; but such exemption shall continue only so long as (A) the conduct of such company's business remains subject to the supervision of such court or officer thereof, and (B) such company does not sell exclusively for cash any security of which it is the issuer, except short-term paper and ordinary receiver's or trustee's certificates.

(b) Upon application by any employees' securities company, the Commission shall be order exempt such company from the provisions of this title and of the rules and regulations hereunder, if and to the extent that it finds such exemption consistent with the protection of investors. In determining the provisions to which such an order of exemption shall apply, the Commission shall give due weight, among other things, to the form or organization and the capital structure of such company, the persons by whom its voting securities, evidence of indebtedness, and other securities are owned, controlled, and held, the prices at which securities issued by such company are sold and the sales load thereon, the disposition of the proceeds of such sales, the character of the securities in which such proceeds are invested, and any relationship between such company and the issuer of any such security.

(c) The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that the Commission finds such exemption necessary or appropriate in the public interest and consistent with the protection of investors.

(d) If, in connection with any rule, regulation, or order under this section exempting any investment company from any provision of section 7, the Commission deems it necessary or appropriate in the public interest or for the protection of investors that certain specified provisions of this title pertaining to registered investment companies shall be applicable in respect of such company, the provisions so specified shall apply to such company, and to other persons in their transactions and relations with such company, as though such company were a registered investment company.

TRANSACTIONS BY UNREGISTERED INVESTMENT COMPANIES

SEC. 7. (a) No management investment company or face-amount certificate company, unless exempted from the provisions of this subsection pursuant to section 6 or effectively registered under section 8, shall directly or indirectly—

(1) offer for sale, sell, or deliver after sale, by the use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security, whether the issuer of such security is such investment company or another person; or offer for sale, sell, or deliver after sale any such security or interest, having reason to believe that such security or interest will be made the subject of a public offering by use of the mails or any means or instrumentality of interstate commerce;

(2) purchase, redeem, retire, or otherwise acquire or attempt to acquire, by use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security, whether the issuer of such security is such investment company or another person;

(3) control any investment company which does any of the acts enumerated in paragraphs (1) and (2);

(4) engage in any business in interstate commerce; or

(5) control any company which is engaged in any business in interstate commerce.

The provisions of this subsection shall not apply to transactions of an investment company which are merely incidental to its dissolution.

(b) No depositor or trustee of or underwriter for a unit investment trust, unless such trust is exempted from the provisions of this subsection pursuant to section 6 or effectively registered under section 8, shall directly or indirectly—

(1) offer for sale, sell, or deliver after sale, by use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security of which such trust is the issuer; or offer for sale, sell, or deliver after sale any such security or interest, having reason to believe that such security or interest will be made the subject of a public offering by use of the mails or any means of instrumentality of interstate commerce;

(2) purchase, redeem, or otherwise acquire or attempt to acquire, by use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security of which such trust is the issuer; or

(3) sell or purchase for the account of such trust, by use of the mails or any means or instrumentality of interstate commerce, any security or interest in a security, by whomever issued.

(c) No promoter of a proposed investment company, and no underwriter for such a promoter, shall make use of the mails or any means or instrumentality of interstate commerce directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any preorganization certificate or subscription for such a company.

(d) No investment company, unless organized under the laws of the United States or of a State, and no underwriter for a company otherwise organized, shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer.

REGISTRATION OF INVESTMENT COMPANIES

SEC. 8. (a) Any investment company organized under the laws of the United States or of a State may register for the purposes of this title by filing with the Commission a notification of registration, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors. An investment company shall be deemed to be registered upon receipt by the Commission of such notification of registration.

(b) It shall be the duty of every registered investment company to file with the Commission, within such reasonable time after registration as the Commission shall fix by rules and regulations or order, an original and such copies of a registration statement, in such form and containing such of the following information and documents, as the Commission shall by rules and regulations or order prescribe as necessary or appropriate in the public interest or for the protection of investors:

(1) a description of the investment and management policies and of the business done and to be done by the registrant, including a designation of—

(A) the class and subclasses of investment company, as defined in or pursuant to sections 4 and 5, within which the registrant falls and within which the registrant proposes to operate in the future;

(B) the activities other than investment in which the registrant is engaged and proposes to engage, such as trading, underwriting, acting as investment adviser, and participating in or influencing the management of companies outstanding securities of which are held by the registrant; and

(C) the characteristics, amounts, and relative amounts of securities and other assets which the registrant has acquired and proposes to acquire in the course of its business;

(2) the information and documents which would be required to be filed in order to register under the Securities Act of 1933 all securities which the registrant is authorized to issue; and

(3) additional pertinent information and documents regarding the registrant, affiliated persons thereof, and underwriters therefor.

(c) In lieu of filing information and documents required pursuant to paragraph (2) of subsection (b), any registrant which has filed a registration statement under the Securities Act of 1933 or the Securities Exchange Act of 1934, which registration statement is currently effective, may file—

(1) such copies of such registration statement or portions thereof, and such copies of reports theretofore filed by the registrant pursuant to section 13 or 15 (d) of the Securities Exchange Act of 1934, as the Commission shall designate by rules and regulations or order; and

(2) a report containing such current information and documents, regarding the matters included in such registration statement and reports, as the Commission shall prescribe by rules and regulations or order as necessary or appropriate in the public interest or for the protection of investors.

(d) Whenever the Commission, on its own motion or upon application, finds that a registered investment company has ceased to be an investment company, it shall so declare by order and upon the taking effect of such order the registra-

tion of such company shall, upon such terms and conditions as the Commission finds and in such order prescribes as necessary for the protection of investors, cease to be in effect. The Commission's denial of any application under this subsection shall be by order.

REGISTRATION OF CERTAIN AFFILIATED PERSONS AND UNDERWRITERS

SEC. 9. (a) It shall be unlawful for any person, unless registered under this section, to serve or act in any of the following capacities for a period exceeding sixty days:

(1) as officer, director, manager, or investment adviser of or for a registered management investment company or registered face-amount certificate company;

(2) as depositor, manager, or investment adviser of or for a registered unit investment trust;

(3) as principal underwriter for a registered open-end management investment company, registered unit investment trust, or registered face-amount certificate company; or

(4) as a distributor who makes use of the mails or any means or instrumentality of interstate commerce to engage in the business of selling periodic payment plan certificates, or as a salesman for such a distributor.

(b) Any person whose registration under this section is required solely because such person is an investment adviser for a registered investment company shall be deemed registered under this section so long as such person is registered under section 204 of title II of this Act.

(c) Any of the persons enumerated in subsection (a), and any person who presently contemplates becoming such an officer, director, manager, investment adviser, depositor, principal underwriter, distributor, or salesman may be registered under this section by filing with the Commission an application for registration. Such application shall contain such information and documents, in such form and such detail, as to such person and affiliated persons of such person as the Commission may by rules and regulations prescribe as necessary or appropriate to effectuate the purposes of this title. Except as hereinafter provided, such registration shall become effective thirty days after receipt of such application by the Commission, or within such shorter period of time as the Commission may determine. Any amendment of an application filed not more than fifteen days after the filing of such application shall be deemed to have been filed with and as a part of such application. Any amendment of an application filed more than fifteen days after the filing of such application shall be deemed a new application incorporating by reference the unamended items of the earlier application.

(d) The Commission shall by order deny registration to, or revoke or suspend the registration of, an applicant under this section, if the Commission finds that such denial, revocation, or suspension is in the public interest and that—

(1) the applicant, within ten years of the issuance of such order, has been convicted of any felony or misdemeanor involving the purchase or sale of any security or arising out of the applicant's conduct as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company;

(2) the applicant, at the time of the issuance of such order, is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security;

(3) the application, as amended, omits any material fact required to be stated therein; or

(4) the applicant has willfully violated section 34 (b), of this title, or that portion of section 203 of title II of this Act which incorporates the provisions of said section 34 (b).

(e) The commencement of a proceeding to deny registration under this section shall operate to postpone the effective date of registration pending final determination of such proceeding.

AFFILIATIONS INVOLVING CONFLICTS OF INTEREST

SEC. 10. (a) After one year from the effective date of this title, no registered investment company shall have a board of directors or an executive committee more than a minority of the members of which consists of—

(1) affiliated persons of any one company other than such registered company; or

(2) persons who regularly act as manager, investment adviser, broker, or principal underwriter of or for such registered company, or affiliated persons of such persons.

(b) Notwithstanding subsection (a), more than a minority of the members of such a board or committee may consist of persons whose only common affiliation (except with such registered company) is with—

(1) an investment company in the same investment company system with such registered company;

(2) a bank, if each such person was a member of such board or committee on the effective date of this title; or

(3) an investment adviser registered under section 204 of title II of this Act, if (A) such investment adviser is engaged in no business other than that of an investment adviser; (B) the sales load on securities issued by such registered company does not exceed 1 per centum of the price to the public; (C) such registered company has no manager other than such investment adviser, and such investment adviser does not receive a management fee exceeding one-half of 1 per centum per annum of the value of such company's net assets averaged over the year or taken as of a definite date within the year; (D) all expenses of such registered company, excepting only taxes and brokerage expenses, are paid by such investment adviser; and (E) at least one-third of the members of the board of directors and of the executive committee of such registered company are persons other than such investment adviser or affiliated persons of such investment adviser.

(c) After one year from the effective date of this title, no registered investment company shall have as director any person who is an investment banker, a broker, or an affiliated person of an investment banker or broker, if such person is a director, officer, or manager of an investment company which is not in the same investment company system with such registered company.

(d) After one year from the effective date of this title, it shall be unlawful for any of the following persons to serve or act as investment officer or manager of a registered investment company:

(1) any officer or manager of an investment company which is not in the same investment company system with such registered company;

(2) any director or officer of a bank who was not a director or officer of such registered company on the effective date of this title;

(3) any person who regularly acts as broker for such registered company;

(4) if such registered company is an open-end management investment company, any principal underwriter therefor; or

(5) any affiliated person of any of the foregoing.

No provision of this subsection shall be construed to prohibit a person from serving or acting as investment officer, manager, broker, or principal underwriter of or for an investment company, merely because such person, though not a manager of any other investment company, is an investment adviser of another such company.

(e) After one year from the effective date of this title, it shall be unlawful for any director or officer of a registrered investment company to serve or act as director or officer of an issuer any outstanding security of which is owned by such registered company, if—

(1) such registered company owns less than 5 per centum of the outstanding voting securities of such issuer; or

(2) such director or officer is an investment banker, a broker, or an affiliated person of an investment banker or broker.

(f) It shall be unlawful for any director or officer of a registered investment company, or any investment banker or broker of which such a director or officer is an affiliated person, to serve or act as principal underwriter for any issuer of which such registered company owns more than one-half of 1 per centum of any class of securities outstanding.

(g) No registered investment company shall purchase or otherwise acquire any security a principal underwriter of which is a director, officer, or manager of such company, or is an investment banker or broker of which such a director, officer, or manager is an affiliated person, unless—

(1) in acquiring such security such registered company is itself acting as a principal underwriter for the issuer; or

(2) such security was first offered to the public by the issuer or by or through an underwriter more than one year prior to such acquisition.

(h) Any reciprocal arrangement for the purpose of evading the provisions of subsection (d) or (f) shall be deemed a violation of this title by the persons concerned, and if such arrangement is known to the registered investment company concerned, a violation of this title by such company.

(i) In the case of a registered management investment company which is an unincorporated company not having a board of directors, the provisions of this section, instead of applying to such company and affiliated persons thereof, shall apply, respectively, to every depositor or manager of such company and to affiliated persons of such depositor or manager.

RECURRENT PROMOTION OF INVESTMENT COMPANIES

Sec. 11. (a) It shall be unlawful for any promoter of a registered investment company organized on or after March 1, 1940, to serve or act as director, officer, manager, investment adviser, depositor, trustee, or principal underwriter of or for such company, if within five years such person, or any company of which such person was then an affiliated person, has been a promoter of another investment company.

(b) It shall be unlawful for any promoter of a registered investment company organized on or after March 1, 1940, to serve or act as investment adviser of or principal underwriter for such company if at the same time such person, or any company of which such person is an affiliated person, is serving or acting as officer, manager, investment adviser, depositor, or principal underwriter of or for another registered investment company.

(c) No registered investment company (other than a face-amount certificate company) shall issue any security (other than short-term paper) representing an interest in or claim against only a class of the issuer's assets, unless such class of assets was created, and securities representing interests exclusively in or claims exclusively against such class were offered and sold to the public prior to March 1, 1940.

(d) Upon application by a registered investment company, or by a promoter of a registered investment company or of a proposed investment company, the Commission shall by order conditionally or unconditionally exempt such company or promoter from a provision or provisions of this section, if the Commission finds that such exemption is consistent with the purposes of this title. In considering such application the Commission shall give due weight to the organization and practices of the company concerned, the history and practices of any promoter concerned, the history and practices of the investment companies with which such promoter has been associated, and the possibility that the granting of such application will subject such company or promoter to conflicting duties or interests.

FUNCTIONS OF INVESTMENT COMPANIES; FORMATION OF INVESTMENT COMPANY SYSTEMS

Sec. 12. (a) It shall be unlawful for any registered investment company—

(1) to purchase any security on margin or credit (except such short-term credits, necessary for the clearance of transactions, as the Commission may designate by rules and regulations or order);

(2) to participate on a joint or a joint and several basis in any trading account in securities;

(3) to effect a short sale of any security, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors; or

(4) to act as a dealer in or distributor of securities of which it is the issuer, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) It shall be unlawful for any diversified investment company to act as underwriter, whenever the amount of its outstanding underwriting commitments, plus the value of its investments in securities other than marketable securities and in securities of issuers of which it owns more than 5 per centum of any class of securities outstanding, exceeds 15 per centum of the value of its total assets.

(c) It shall be unlawful for any registered investment company to purchase or otherwise acquire any security issued by, or any other interest in the business of—

(1) any other investment company, except (A) in connection with a plan of reorganization or offer of exchange for which a declaration is effective under section 25, or (B) with the proceeds of payments on periodic payment plan certificates, pursuant to the terms of the trust indenture under which such certificates are issued; or

(2) any person who is a broker, dealer, underwriter, manager, or investment adviser, unless (A) such person is a corporation all of the outstanding securities of which (other than short-term paper) are, or after such acquisition will be, owned by such registered company; and (B) the business of such person is confined to activities in which such registered company itself may lawfully engage.

CHANGES IN INVESTMENT POLICY

Sec. 13. (a) No registered diversified investment company shall become a securities trading company or securities finance company, unless such change is authorized by the vote of a majority of its outstanding voting securities.

(b) No registered investment company shall change any fundamental investment or management policy unless each such change is authorized by the vote of a majority of its outstanding voting securities. The Commission, by rules and regulations or order, shall designate those investment and management policies which are fundamental, giving due weight, among other things, to the representations made in selling the outstanding securities of the company or companies concerned, to the representations made in their registration statements and reports filed under this title and in their reports to security holders, to the history of their investment and managerial policies, and to their financial condition.

SIZE OF INVESTMENT COMPANIES

Sec. 14. (a) No registered investment company or principal underwriter therefor shall sell any security of which such company is the issuer (other than short-term paper), if such company has, or upon completing such sale will have, total assets the value of which exceeds the following maxima:

(1) if such company is a diversified investment company or a unit investment trust, $150,000,000;

(2) if such company is a securities trading or securities finance company, $75,000,000;

(3) if such company is a face-amount certificate company, $200,000,000.

(b) The provisions of subsection (a) shall not apply to—

(1) the sale of a security by an open-end management investment company, if the proceeds received by the issuer from all such sales during the fiscal quarter within which such sale is made do not exceed such issuer's total disbursements for redemptions during the same fiscal quarter; or

(2) a sale made pursuant to an offer required by any rule, regulation, or order of the Commission under paragraph (2) of section 19 (a).

(c) No person who regularly serves or acts as manager or investment adviser of a registered investment company, and no affiliated person of such a person, shall enter into, renew, or consent to the renewal of, any contract to receive remuneration for serving or acting as manager or investment adviser of another investment company, if the value of the combined total assets of such companies exceeds the following maxima:

(1) if either of such companies is a securities trading or securities finance company, $75,000,000;

(2) if both such companies are face-amount certificate companies, $200,000,000;

(3) under any circumstances other than those described in paragraphs (1) and (2), $150,000,000.

(d) No registered investment company organized after March 1, 1940, and no principal underwriter for such a company, shall make a public offering of securities of which such company is the issuer, unless—

(1) such company has a net worth of at least $100,000; or

(2) such company has previously made a public offering of its securities, and at the time of such offering had a net worth of at least $100,000.

COMPENSATION OF MANAGEMENT; MANAGEMENT AND UNDERWRITING CONTRACTS

SEC. 15. (a) After one year from the effective date of this title, it shall be unlawful for any person regularly to serve or act as officer, director, manager, investment adviser, or employee of any registered investment company, unless such person's compensation from such company is determined on one or more of the following bases, and no other:

(1) a definite sum of money per year, month, or other definite period;

(2) a sum of money representing a definite percentage of such company's income from interest and dividends during a definite period; or

(3) a sum of money representing a definite percentage of the value of the net assets of such company as of a definite date or averaged over a definite period.

(b) After one year from the effective date of this title it shall be unlawful for any person regularly to serve or act as manager or investment adviser of a registered investment company, except pursuant to a written contract with such company, approved by the vote of a majority of the outstanding voting securities of such company, which contract—

(1) precisely describes all compensation to be paid thereunder;

(2) by its terms expires not later than two years from the date of its execution, and is renewable thereafter only by the specific approval annually of the board of directors or the security holders of such registered company;

(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the manager or investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment or attempted assignment by the manager or investment adviser.

(c) After one year from the effective date of this title, it shall be unlawful for any principal underwriter for a registered open-end management investment company or registered unit investment trust to offer for sale, sell, or deliver after sale any security of which such company is the issuer, except pursuant to a written contract with such company which—

(1) by its terms expires not later than one year from the date of its execution, and is renewable thereafter only by the specific approval annually of the board of directors or of the security holders of such registered company; and

(2) provides, in substance, for its automatic termination in the event of its assignment or attempted assignment by such underwriter.

(d) It shall be unlawful for any registered investment company having a board of directors to enter into or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as manager, investment adviser, underwriter, or broker for such company, unless the terms of such contract or agreement have been approved by a majority of such directors, exclusive of any director who is himself a party to such contract or agreement or who is an affiliated person of such a party.

(e) If any registered investment company, or any company controlled by or under common control with such a company, is serving or acting, or proposes to serve or act, as manager or investment adviser of another company or companies in the same investment company system with such registered company, the Commission shall require, by such rules and regulations or orders as it finds necessary or appropriate in the public interest or for the protection of investors, that such manager or investment adviser serve such other company or companies at cost, and that such cost be equitably allocated between and among such registered company and such other company or companies.

CHANGES IN BOARD OF DIRECTORS

SEC. 16. No person shall serve as director of a registered investment company unless elected to that office by the holders of the outstanding voting securities of such company, at the annual or a special meeting of such security holders duly called for that purpose; except that vacancies occurring between such meetings, not exceeding in the aggregate one-third of the whole number of the board of directors, may be filled in any otherwise legal manner.

TRANSACTIONS OF CERTAIN AFFILIATED PERSONS AND UNDERWRITERS

SEC. 17. (a) It shall be unlawful for any affiliated person of or principal underwriter for a registered investment company, or any affiliated person of such a person or underwriter, acting as principal—

(1) knowingly to sell any security or other property to such registered company or an affiliated company thereof (unless such sale consists solely of (A) the redemption of redeemable securities by their issuer, or (B) the deposit of securities with the trustee of a unit investment trust or periodic payment plan by the depositor thereof);

(2) knowingly to purchase from such registered company or any affiliated company thereof any security or other property (except securities of which the seller is the issuer);

(3) to borrow money or other property from such registered company or an affiliated company thereof (unless the borrower is controlled by the lender); or

(4) to effect any transaction in which such registered company or an affiliated company thereof is a joint or a joint and several participant with such person, underwriter, or affiliated person, in contravention of such rules and regulations as the Commission may prescribe for the purpose of (A) limiting or preventing participation by such company on a basis different from or less advantageous than that of such other participant, and (B) protecting the independent investment and managerial judgment of such company.

(b) Notwithstanding subsection (a), a company which controls or is controlled by a registered investment company or which, with such registered company, is under the common control of another company, may file with the Commission an application for an order exempting a proposed transaction of the applicant from one or more provisions of that subsection. The Commission shall grant such application and issue such order of exemption if it find that—

(1) the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned;

(2) the proposed transaction is consistent with the investment and management policies of each registered investment company concerned as recited in its registration statement and reports filed under this title; and

(3) the proposed transaction is consistent with the purposes of this title.

(c) Notwithstanding subsection (a), a person may sell merchandise in the ordinary course of business to any affiliated company of a registered investment company if such affiliated company is not itself an investment company.

(d) It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such a person—

(1) acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any affiliated company thereof, except in the course of such person's business as an underwriter or broker; or

(2) acting as broker, to sell any security to or for such registered company or any affiliated company thereof, if such person receives from any source a commission, fee, or other remuneration for effecting such transaction which exceeds the usual and customary broker's commission for effecting similar transactions on a national securities exchange.

(e) Any gross misconduct or gross abuse of trust in respect of a registered investment company, on the part of any person registered under section 9 as an affiliated person of or principal underwriter for such company, shall be unlawful.

(f) After one year from the effective date of this title, it shall be unlawful for the charter, certificate of incorporation, articles of association, bylaws, or trust

indenture of any registered investment company, for any employment management, underwriting, or brokerage contract or agreement to which such a company is a party, or for any other instrument pursuant to which such a company is organized or administered, to contain any provision which—

(1) authorizes, or purports to authorize, the violation of any provision of this title or of any rule, regulation, or order hereunder; or

(2) relieves, or purports to relieve, any affiliated person of or principal underwriter for such company from any duty or liability to such company or the security holders thereof to which such person or underwriter would otherwise be subject.

(g) The Commission is authorized to require, by rules and regulations or order in the public interest or for the protection of investors—

(1) that securities and other investments of a registered management investment company be placed in the custody of an institution having the qualifications required by paragraph (1) of section 26 (a) for the trustees of unit investment trusts; and

(2) that any person or class of persons registered under section 9 be required to be bonded by a reputable fidelity insurance company in such minimum amount as the Commission may prescribe.

(h) Every person registered under section 9 as a distributor of periodic payment plan certificates shall be subject, in his transactions with the issuer of such certificates, to the same duties and liabilities as those imposed by this section upon affiliated persons of registered investment companies in their transactions with such companies.

CAPITAL STRUCTURE

Sec. 18. (a) It shall be unlawful for any registered management investment company to issue any security (other than short-term paper or periodic payment plan certificates), or to sell any such security of which it is the issuer, unless such security—

(1) is a common stock, or if such company is an unincorporated company organized prior to March 1, 1940, is a security having substantially the same incidents as the common stock of a corporation;

(2) has no preference as to distribution or dividends over any outstanding security of such company;

(3) is a voting security, and has equal voting rights with every voting security of such company issued since the effective date of this title; and

(4) if not a redeemable security, expressly provides that the holder thereof shall be given a reasonable opportunity, with other holders of the company's voting securities, to subscribe for and purchase ratably any voting securities which the company may thereafter issue, before such securities are sold to any other person or persons.

If such company is an unincorporated company organized prior to March 1, 1940, the Commission shall designate, by rules and regulations or order in the public interest and for the protection of investors, those incidents which such security must have in order substantially to comply with the requirements of this subsection.

(b) The provisions of paragraphs (1) and (2) of subsection (a) shall not apply to the issuance or sale of a preferred or special stock if the only other outstanding class of the issuer's equity securities consists of a common stock upon which no dividend (other than a liquidating dividend) is permitted to be paid and which in the aggregate represents not more than one-half of 1 per centum of the issuer's outstanding voting securities.

(c) It shall be unlawful for any registered management investment company to issue any warrant or right to subscribe to or purchase a security of which such company is the issuer, except—

(1) in the form of warrants or rights to subscribe expiring not later than one hundred and twenty days after their issuance and issued exclusively and ratably to a class or classes of such company's security holders; or

(2) in the form of periodic payment plan certificates.

(d) After two years from the effective date of this title, the Commission shall, upon application by the holder of any outstanding security of a registered management investment company, and may upon its own motion, require by order that

such company, and every other registered investment company in the same investment company system, take such steps as are necessary or appropriate to effect an equitable redistribution of voting rights and privileges among the holders of the outstanding securities of such company or companies.

DIVIDENDS

SEC. 19. (a) It shall be unlawful for any registered investment company to declare or pay any dividend, or make any distribution in the nature of a dividend, wholly or partly from any source other than such company's aggregate undistributed net income from interest and dividends, unless—

(1) the payment of a dividend from such other source is either expressly permitted by the charter, certificate of incorporation, or other instrument pursuant to which such company is organized or such payment, not being prohibited by such instrument, has been approved by the vote of a majority of such company's outstanding voting securities; and

(2) the dividend check is accompanied by a written statement, in such form as the Commission may by rules and regulations prescribe, which (A) fully discloses the source or sources of such dividend, and (B) gives the recipient such reasonable opportunity to invest in securities of said company, without the payment of any sales load, such substantial portion of said dividend paid out of a source other than net income from interest and dividends, as the Commission shall prescribe by rules and regulations or order.

(b) It shall be unlawful for any registered management investment company to declare or pay a dividend on a security, unless immediately after such payment every class of the outstanding securities of such company senior to the security upon which such dividend is paid has the asset coverage hereinafter prescribed. For the purposes of this subsection, the "asset coverage" of a class of outstanding securities means the ratio which the value of the total assets of the issuer, as of the end of the period to which the dividend relates, less its liabilities not evidenced by securities, its liabilities evidenced by short-term paper and the total liquidation preferences of all outstanding securities senior to such class, bears to the total liquidation preferences of all outstanding securities of such class. The prescribed asset coverage for a class of senior securities other than evidences of indebtedness shall be 200 per centum; but the Commission, by rules and regulations or order for the protection of investors or to preserve the financial integrity of the company or companies concerned, may prescribe a higher asset coverage, in no event exceeding 300 per centum, or a lower asset coverage, in no event less than 150 per centum. The prescribed asset coverage for evidences of indebtedness shall be 300 per centum; but the Commission, by rules and regulations or order for the protection of investors or to preserve the financial integrity of the company or companies concerned, may prescribe a higher asset coverage, in no event exceeding 400 per centum, or a lower asset coverage, in no event less than 200 per centum.

(c) No provision of this section shall apply to a liquidating dividend declared or paid in connection with a plan of total or partial liquidation of the company concerned, which plan has been approved by the security holders of such company in accordance with State law.

PROXIES; VOTING TRUSTS; CIRCULAR OWNERSHIP

SEC. 20. (a) It shall be unlawful for any person to solicit or to permit the use of his or its name to solicit, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, any proxy, power of attorney, consent, or authorization regarding any security of a registered investment company in contravention of such rules and regulations or orders as the Commission may prescribe for the purpose of insuring to the persons solicited—

(1) a form of proxy, power of attorney, consent, or authorization which clearly presents the alternative choices available to such persons; and

(2) information sufficient to permit the exercise of an informed judgment in choosing between such alternatives.

(b) It shall be unlawful for any registered investment company or affiliated person thereof, any issuer of a voting trust certificate relating to any security of a registered investment company, or any underwriter of such a certificate, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, to offer for sale, sell, or deliver after sale, in connection with a public offering, any such voting trust certificate.

(c) No registered investment company shall purchase or otherwise acquire any voting security if, to the knowledge of such registered company, cross-ownership or circular ownership exists, or after such acquisition will exist, between such registered company and the issuer of such security. Cross-ownership shall be deemed to exist between two companies when each of such companies beneficially owns more than 1 per centum of the outstanding voting securities of the other company. Circular ownership shall be deemed to exist between two companies if such companies are included within a group of three or more companies, each of which—

(1) beneficially owns more than 1 per centum of the outstanding voting securities of one or more other companies of the group; and

(2) has more than 1 per centum of its own outstanding voting securities beneficially owned by another company, or by each of two or more other companies, of the group.

(d) If on the effective date of this title cross-ownership or circular ownership exists between a registered investment company and any other company or companies, it shall be the duty of such registered company, within three years after such effective date, to eliminate such cross-ownership or circular ownership. If at any time after the effective date of this title cross-ownership or circular ownership between a registered investment company and any other company or companies comes into existence, it shall be the duty of such registered company within one year after it first knows of the existence of such cross-ownership or circular ownership, to eliminate the same.

LOANS

SEC. 21. (a) It shall be unlawful for any registered management investment company to lend money or property to any natural person, directly or indirectly.

(b) It shall be unlawful for any registered management investment company to lend money or property to any company, directly or indirectly, if—

(1) the company receiving the loan is in control of or under common control with such registered company; or

(2) the investment and management policies of such registered company, as recited in its registration statements and reports filed under this title, do not specifically authorize such a loan.

(c) It shall be unlawful for any registered management investment company to borrow money, directly or indirectly, except—

(1) from a company which controls such registered company;

(2) from a natural person who is an affiliated person of such company; or

(3) from a bank or other person, for temporary purposes only and in an amount not exceeding 5 per centum of the value of such registered company's total assets.

A loan shall be presumed to be for temporary purposes if it is repaid within sixty days and is not renewed or extended; otherwise it shall be presumed not to be for temporary purposes. Any such presumption may be rebutted by evidence. The provisions of this subsection shall not apply to the extension or renewal until not later than July 1, 1945, of any loan made prior to March 1, 1940.

DISTRIBUTION, REDEMPTION, AND REPURCHASE OF REDEEMABLE SECURITIES

SEC. 22. (a) No registered investment company or principal underwriter therefor shall sell, redeem, or repurchase any redeemable security of which such a company is the issuer, except at a price bearing such relation to the current asset value of such security, computed as of such time, as the Commission shall prescribe by rules and regulations or orders, for the purpose of eliminating or reducing to a practical minimum any dilution of or accretion to the current asset value of any other securities of such company as a consequence of such sale, redemption, or repurchase.

(b) No underwriter or dealer, in connection with a primary distribution of redeemable securities of which any registered investment company is the issuer, shall purchase any such security from the issuer or from any underwriter except at the price at which he sells such security, less a commission or spread allowed him by the person selling to him.

(c) If at any time the Commission has reason to believe that any redeemable security is being offered for sale or sold to the public by the issuer or any underwriter at a price which includes an unconscionable or grossly excessive sales load,

the Commission shall cause to be served upon the issuer (or if the issuer is a unit investment trust, upon its depositor), and upon every principal underwriter for the issuer, a notice to appear and show cause why such sales load should not be prohibited. If, after hearing the evidence, the Commission finds that the issuer or any principal underwriter therefor is selling such securities to the public at a price including an unconscionable or grossly excessive sales load, the Commission shall order such company, underwriter, or underwriters, as the case may be, to cease and desist from selling at such price. In determining whether a sales load is unconscionable or grossly excessive, due weight shall be given to the incidents, denominations, and selling price of the securities involved, to the organization, investment policy, past and prospective earnings, management expenses, and management and sales methods of the issuer, its managers, depositors, underwriters, and dealers and its and their competitors, and to such other factors as are relevant in the particular proceeding.

(d) The Commission is authorized, by rules and regulations or order in the public interest or for the protection of investors, to prohibit—

(1) the suspension, in whole or in part, of the redemption privileges of any redeemable security of which any registered investment company is the issuer; and

(2) restrictions upon the transferability or negotiability of any redeemable security of which any registered investment company is the issuer.

DISTRIBUTION AND REPURCHASE OF SECURITIES: CLOSED-END MANAGEMENT INVESTMENT COMPANIES

SEC. 23. (a) No registered closed-end management investment company shall issue any security, or sell any security of which it is the issuer, in contravention of such rules and regulations or orders as the Commission may prescribe in the public interest or for the protection of investors to prevent or limit such issuance or sale at a price below the current asset value of the security.

(b) No registered closed-end management investment company shall purchase, call, or retire any securities of which it is the issuer in contravention of such rules and regulations or orders as the Commission may prescribe in the public interest or for the protection of investors to prevent such purchase, call, or retirement in a manner or on a basis which unfairly discriminates against any security holders or any class of the security holders of such registered company.

REGISTRATION OF SECURITIES UNDER SECURITIES ACT OF 1933

SEC. 24. (a) No registered investment company or principal underwriter therefor shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer (other than short-term paper), unless such security is effectively registered under the Securities Act of 1933, any exemptive provision of said Act to the contrary notwithstanding.

(b) In registering under the Securities Act of 1933 any security of which it is the issuer, a registered investment company, in lieu of furnishing a registration statement containing the information and documents specified in Schedule A of said Act, may file a registration statement containing the following information and documents:

(1) such copies of the registration statement filed by such company under this title, and of such periodic and special reports filed by such company pursuant to section 30 (a) of this title, or such copies of portions of such registration statement and reports, as the Commission shall designate by rules and regulations or order; and

(2) such additional information and documents (including a prospectus) as the Commission shall prescribe by rules and regulations or order as necessary or appropriate in the public interest or for the protection of investors.

(c) It shall be unlawful for any of the following companies, or for any underwriter for such a company, to employ, in the sale of any security registered under the Securities Act of 1933 of which such company is the issuer, any pamphlet, circular, form letter, or other sales literature, unless such literature has been filed with the registration statement of said security under said Act, as an accompanying document or as an amendment of such registration statement:

(1) any registered open-end management investment company;
(2) any registered unit investment trust;
(3) the issuer of any periodic-payment-plan certificate; or
(4) any registered face-amount certificate company.

(d) In addition to the powers relative to prospectuses granted the Commission by section 10 of the Securities Act of 1933, the Commission is authorized and directed to require, by rules and regulations or order, that the information contained in any prospectus relating to a security registered under the Securities Act of 1933 on or after the effective date of this title, of which any of the companies enumerated in subsection (c) is the issuer, shall be presented in such form and order of items, and contain such summaries of any portion of such information, as the Commission deems necessary or appropriate in the public interest or for the protection of investors.

PLANS OF REORGANIZATION AND DISSOLUTION AND OFFERS OF EXCHANGE

SEC. 25. (a) Except in accordance with a declaration filed under subsection (c) and an order of the Commission permitting such declaration to become effective, it shall be unlawful—

(1) for any person to solicit or permit the use of his or its name to solicit, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, any proxy, consent, authorization, power of attorney, ratification, deposit, or dissent in respect of any plan of reorganization, or of voluntary dissolution or liquidation, or any plan for the restatement of the capital, of a registered investment company;
(2) for any person, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, to issue, offer for sale, sell, or deliver after sale, pursuant to any such plan, any security or other property;
(3) for any person to submit any such plan to any court of the United States for approval; or
(4) for any court of the United States to approve any such plan.

Provided, That the provisions of this subsection shall not apply to a plan of voluntary dissolution or liquidation of a registered investment company more than 75 per centum of the value of whose assets consist of marketable securities, Government securities, and cash items.

(b) Except in accordance with a declaration filed under subsection (c) and an order of the Commission permitting such declaration to become effective, it shall be unlawful for any registered investment company or principal underwriter therefor to issue or sell for any consideration other than cash, any security (other than short-term paper) of which such company is the issuer.

(c) A declaration regarding any of the acts enumerated in subsections (a) and (b) shall be filed with the Commission in such form, and shall contain such information and documents, as the Commission may by rules and regulations or order prescribe as necessary or appropriate in the public interest or for the protection of investors. If the declaration relates to a reorganization or other plan in which the declarant has no bona fide interest, the Commission shall by order dismiss such declaration. Unless the declaration is so dismissed, or is withdrawn by the declarant, the Commission shall enter an order either permitting such declaration to become effective as filed or amended, or refusing to permit such declaration to become effective. Amendments to a declaration may be made upon such terms and conditions as the Commission may prescribe.

(d) An order under subsection (c) refusing to permit a declaration to become effective shall be entered by the Commission only if the Commission finds that the plan or offer of exchange to which the declaration relates—

(1) is not fair and equitable to all persons and classes of persons affected thereby;
(2) in the case of a plan of reorganization, is not feasible; or
(3) is inconsistent with the purposes of this title.

(e) The Commission, by rules and regulations on its own motion, or by order on its own motion or upon application, shall conditionally or unconditionally except from any provision of this title or of section 5 of the Securities Act of 1933 any transaction or class of transactions provided for in a plan or offer of exchange for which a declaration is effective under this section, if the Commission finds that such exemption is consistent with the public interest and the interest of investors, that such transaction or transactions are necessary or appro-

priate to the effectuation of such plan or offer of exchange, and that such plan or offer of exchange will tend to effectuate the purposes of this title.

UNIT INVESTMENT TRUSTS

SEC. 26. (a) No principal underwriter for or depositor of a registered unit investment trust shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale any security of which such trust is the issuer (other than short-term paper), unless the trust indenture or other instrument pursuant to which such security is issued—

(1) designates a trustee or trustees, each of which is an institution incorporated and doing business under the laws of the United States or of a State, is authorized under such laws to exercise corporate trust powers, is subject to supervision or examination by Federal or State authority, and has a combined capital and surplus of such minimum amount as the Commission may specify by rules and regulations or order in the public interest or for the protection of investors;

(2) provides, in substance, (A) that during the life of the trust the trustee, if not otherwise remunerated, may charge against and collect from the income of the trust, and from the corpus thereof if no income is available, such fees for its services and such reimbursement for its expenses as are provided for in such instrument; (B) that no such charge or collection shall be made except for services theretofore performed or expenses theretofore incurred; (C) that no payment to the depositor of or a principal underwriter for such trust, or to any affiliated person or agent of such depositor or underwriter, shall be allowed the trustee as an expense; and (D) that the trustee shall have title to and possession of all securities and other property in which the funds of the trust are invested, all funds held for such investment, all equalization, redemption, and other special funds of the trust, and all income upon and accretions to such property and funds, and shall segregate and hold the same in trust (subject only to the charges and collections allowed under classes (A), (B), and (C)) until distribution thereof to the security holders of the trust; and

(3) provides, in substance, (A) that a record will be kept by the depositor or an agent of the depositor of the name and address of, and the shares issued by the trust and held by, every holder of any security issued pursuant to such instrument, insofar as such information is known to the depositor or agent; and (B) that whenever a security is deposited with the trustee in substitution for any security in which such security holder has an undivided interest, the depositor or the agent of the depositor will, within five days after such substitution, either deliver or mail to such security holder a notice of substitution, including an identification of the securities eliminated and the securities substituted, and a specification of the shares of such security holder affected by the substitution.

(b) It shall be unlawful for any trustee of a registered unit investment trust to resign, unless—

(1) the Commission, on application by such trustee, has by order consented to such resignation; or

(2) a successor trustee has been appointed by a court of competent jurisdiction.

(c) It shall be unlawful for any depositor of a registered unit investment trust voluntarily to resign as depositor, to make or attempt to make an assignment of any of his or its rights or duties with respect to such trust, to dissolve or to pay any liquidating dividend to its security holders, unless the Commission, upon application by such depositor, finds and by order declares that such action by the depositor will not substantially prejudice the interest of the security holders of such trust.

(d) Whenever the Commission has reason to believe that a unit investment trust is inactive and that its liquidation is necessary or appropriate in the public interest or for the protection of investors, the Commission may file a complaint seeking the liquidation of such trust in the district court of the United States in any district wherein any trustee of such trust resides or has its princiapl place of business. A copy of such complaint shall be served on every trustee of such trust, and notice of the proceeding shall be given such other interested persons in such manner and

at such times as the court may direct. If the court determines that such liquidation is necessary or appropriate in the public interest or for the protection of investors, the court shall order such liquidation and after payment of necessary expenses, the distribution of the proceeds to the security holders of the trust in such manner and on such terms as may to the court appear equitable.

PERIODIC PAYMENT PLANS

SEC. 27. (a) It shall be unlawful for any person to make use of the mails or any means or instrumentality of interstate commerce to engage in the business of selling periodic payment plan certificates, if—

(1) the sales load on any such certificate exceeds 9 per centum of the total payments to be made thereon;
(2) more than one-half of any payment during the first year of the plan is deducted for sales load;
(3) the amount of sales load deducted from any payment during the first year of the plan exceeds the amount deducted from any other payment during such year, or the amount deducted from any payment during the subsequent years of the plan exceeds the amount deducted from any other payment during such years; or
(4) either of the first two payments on any such certificate is less than $20, or any subsequent payment is less than $10.

(b) It shall be unlawful for any person, by use of the mails or any means or instrumentality of interstate commerce, to engage in the business of selling periodic payment plan certificates, unless—

(1) each such certificate is a redeemable security; and
(2) the proceeds of all payments on any such certificate (except such amounts as are deducted for sales load) are deposited with a trustee having the qualifications required by paragraph (1) of section 26 (a) for the trustees of unit investment trusts, and are held by such trustee under a trust indenture containing, in substance, the provisions required by paragraph (2) of section 26 (a) for the trust indentures of unit investment trusts.

(c) It shall be unlawful for any trustee with which the proceeds of payments on a periodic payment plan certificate have been deposited to resign, unless—

(1) the Commission, on application by such trustee, has by order consented to such resignation; or
(2) a successor trustee has been appointed by a court of competent jurisdiction.

FACE-AMOUNT CERTIFICATE COMPANIES

SEC. 28. (a) It shall be unlawful for any registered face-amount certificate company to issue or sell any face-amount certificate, or to collect or accept any payment on any such certificate issued by such company on or after the effective date of this title, unless—

(1) capital stock of such company in an amount not less than $250,000 has been bona fide subscribed and paid for in cash; and
(2) such company maintains minimum certificate reserves on all its issued and outstanding face-amount certificates in an agreegate amount calculated and adjusted as follows:

(A) out of each payment required to be made by the holder of every such certificate of the installment type in order to complete one full year's installment payments, a portion of such payment equal to 50 per centum of the amount thereof;
(B) out of every other payment made on any such certificate by the holder thereof, such portion of the payment as will, together with similar portions of all other such payments on such certificate and any portions required by paragraph (A) hereof, with accumulations on all such portions at the rate of 3½ per centum per annum, compounded annually, attain upon the maturity of such certificate an amount equal to the maturity or face amount thereof;
(C) any portion of the profits of such company which such company has undertaken to hold for the account of the holder of any such certificate;

(D) an amount equal to accumulations at the rate of 3½ per centum per annum, compounded annually, on such portions of all past payments on, and such portions of profits credited to, any such certificate; and

(E) such appropriate reserves for contingencies for death and disability benefits, on any such certificate providing for such benefits, as the Commission shall prescribe by rules and regulations.

(b) It shall be unlawful for any registered face-amount certificate company to sell any face-amount certificate, or to collect or accept any payment on any such certificate issued by such company on or after the effective date of this title, unless such company has, in cash or qualified investments, assets having a value not less than the aggregate amount of the capital stock requirement and certificate reserve requirement provided for in subsection (a) hereof. As used in this subsection, "qualified investments" means investments of a kind in which life insurance companies are generally permitted to invest. The Commission is authorized, by rules and regulations or order in the public interest or for the protection of investors, to designate those investments which are qualified and to prescribe the basis of valuation of any such investment.

(c) The Commission is authorized, by rules and regulations or order in the public interest or for the protection of investors, to require any registered face-amount certificate company to deposit and maintain, with an institution having the qualifications required by paragraph (1) of section 26 (a) for the trustees of unit investment trusts, all investments maintained by such company pursuant to the requirements of subsection (b) hereof.

(d) It shall be unlawful for any registered face-amount certificate company to issue or sell any face-amount certificate, unless such certificate provides, in substance, that upon the surrender thereof to the company the holder thereof shall be entitled to receive from the company the following minimum amounts:

(1) an amount equal at all times to 50 per centum of the sum of all past payments on such certificate by the holder thereof; and

(2) such additional amounts, representing such percentages of the certificate reserves of such company, as the Commission shall have prescribed by rules and regulations or order for the purpose of providing an equitable graduation of surrender values.

Any such certificate may provide that the surrender value thereof shall be adjusted to take into account any unpaid balance on any loan made by such company to the holder of such certificate, and to make allowance for such other matters, including a reasonable surrender charge, as the Commission may permit or prescribe by rules and regulations or order in the public interest or for the protection of investors.

(e) It shall be unlawful for any registered face-amount certificate company to issue or sell any face-amount certificate which provides that the holder shall be liable for or charged with any unpaid amount on such certificate.

(f) It shall be unlawful for any registered face-amount certificate company, in the event of a default by the holder in any installment payment on a face-amount certificate of which such company is the issuer, to cancel such certificate, to suspend accumulations at the rate provided for in the certificate upon payments previously made by such holder, or to postpone the maturity date of such certificate, in contravention of such rules and regulations or orders as the Commission may prescribe in the public interest or for the protection of investors.

BANKRUPTCY OF FACE-AMOUNT CERTIFICATE COMPANIES

SEC. 29. (a) Section 67 of an Act entitled "An Act to establish a uniform system of bankruptcy throughout the United States", approved July 1, 1898, as amended, is amended by adding at the end thereof the following:

"f. (1) For the purposes of, and exclusively applicable to, this subdivision f: (a) 'Debtor' shall mean a face-amount certificate company, as defined in section 4 of the Investment Company Act of 1940; (b) 'depositary' is a person with whom securities or other property of a debtor is deposited, or to whom property of a debtor is transferred, in trust or otherwise, pursuant to a State law requiring such deposit or transfer and providing for the distribution of such property or its proceeds to creditors or security holders of the debtor in the event of the insolevncy of the debtor or under other specified circumstances; and (c) 'State agency' is an official or agency of a State designated to act as depositary or to distribute property, or the proceeds of property, held by a depositary.

"(2) Every deposit or transfer of securities or other property made by or on behalf of a debtor with or to any depositary or State agency for the benefit of the holder of any security sold by or on behalf of the debtor on or after October 1, 1940, shall be null and void as against the trustee of such debtor, and such deposit or transfer and every lien created thereby shall be avoided by the trustee for the benefit of the estate.

"(3) The court shall have summary jurisdiction of any proceeding to hear and determine the rights of any parties under this subdivision f. Due notice of any hearing in such proceeding shall be given to every depositary and State agency which is a party in interest."

(b) Section 44 of said Act of July 1, 1898, as amended, is amended by adding at the end of subdivision a thereof the following sentence:

"If the bankrupt is a face-amount certificate company, as defined in section 4 of the Investment Company Act of 1940, the court alone shall make the appointment; but the court shall not make such appointment without first notifying the Securities and Exchange Commission and giving it an opportunity to be heard."

PERIODIC AND OTHER REPORTS

SEC. 30. (a) Every registered investment company, and every manager, investment adviser, principal underwriter, depositor, or distributor registered under section 9, shall file with the Commission such annual, semiannual, quarterly, and other periodic and special reports, the answers to such specific questions and the minutes of such directors', stockholders', and other meetings, as the Commission may by rules and regulations or order prescribe as necessary or appropriate in the public interest or for the protection of investors. The financial statements of such reports, if required by the rules and regulations of the Commission, shall be certified by an independent public accountant, and shall be made and filed at such time and in such form and detail as the Commission shall prescribe. The Commission may require that there be included in reports filed with it such information and documents as it deems necessary or appropriate to keep reasonably current the information filed by such persons under section 8 or 9, and such further information, of a kind which the Commission might require to be included in or to accompany a registration statement filed under section 8 or 9, as the Commission deems necessary or appropriate in the public interest or for the protection of investors.

(b) The Commission shall provide by rules and regulations for the filing with the Commission and with any national securities exchange concerned of copies of periodic and special reports, or of portions of such reports, filed by any registered investment company pursuant to subsection (a), in lieu of any reports required of such company under section 13 or 15 (d) of the Securities Exchange Act of 1934.

(c) The Commission shall require by rules and regulations or order, if and to the extent that the Commission finds such action necessary or appropriate in the public interest or for the protection of investors, that a registered investment company transmit periodic and special reports or notices to the security holders, or specified classes of the security holders, of such company, at such times and in such form and detail as the Commission shall prescribe. Such reports and notices shall contain such of the information contained in registration statements, applications, reports, and other documents relating to such company filed under this title, as the Commission may prescribe by rules and regulations or order as necessary or appropriate in the public interest or for the protection of investors.

(d) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of outstanding securities (other than short-term paper) of which a registered investment company is the issuer, or who is a director or an officer of such a company, shall be subject to the same duties and liabilities as those imposed upon certain beneficial owners, directors, and officers by section 16 of the Securities Exchange Act of 1934.

(e) It shall be the duty of every person registered under section 9 as an affiliated person of any registered management investment company, within thirty days after the end of every fiscal quarter of such company, to submit to the board of directors of the company a statement showing the amounts and dates of every purchase or sale made directly or indirectly for the account of such person, during such fiscal quarter, of the securities of any issuer any outstanding security of which was purchased or sold by such registered company at any time during such fiscal quarter. The provisions of this subsection shall not apply to purchases or sales of Government securities or short-term paper.

ACCOUNTS AND RECORDS

SEC. 31. (a) Every registered investment company, every underwriter, broker, dealer, or investment adviser which is a majority-owned subsidiary of such a company, and every manager, investment adviser, principal underwriter, depositor, or distributor registered under section 9, shall make, keep, and preserve for such periods, such accounts, cost-accounting procedures, correspondence, memoranda, papers, books, and other records as the Commission may prescribe by rules and regulations or order as necessary or appropriate in the public interest, for the protection of investors or for the enforcement of this title.

(b) All accounts, cost-accounting procedures, correspondence, memoranda, papers, books, and other records kept or required to be kept by any person subject to subsection (a) shall be subject at any time and from time to time to such reasonable periodic, special, and other examinations by the Commission, or any member or representative thereof, as the Commission may prescribe. It shall be the duty of any such person to furnish to the Commission, within such reasonable time as the Commission may prescribe, any information with respect to such records which the Commission may by order require.

(c) The Commission, or any member or representative thereof designated by it, shall have power at any time and from time to time to make an examination of all the affairs of any registered investment company.

(d) The Commission, by rules and regulations in the public interest or for the protection of investors, may prescribe for registered investment companies or classes or subclasses of registered investment companies—

(1) uniform methods for keeping accounts and other records required to be kept pursuant to subsection (a), including, among other things, uniform methods of (A) classifying and segregating accounts, (B) recording and carrying securities and other assets, and (C) differentiating between capital and income; and

(2) the methods, practices, and procedures to be followed in determining the entries to be made in accounts, books, and other records required to be kept pursuant to subsection (a), including, among other things, methods, practices, and procedures of determining (A) cost of assets; (B) the value of assets; (C) profits, losses, income, and expenses; (D) the incurrence and discharge of liabilities and contingent liabilities; (E) the entries to reflect the issuance, sale, exchange, acquisition, redemption, or retirement of any security of which such a company is the issuer; (F) the adjustment of accounts upon the restatement of any asset or liability or any capital or surplus account; and (G) the entries providing for depreciation or reflecting appreciation of assets.

(e) For the purpose of enforcing the rules and regulations of the Commission under subsection (d) and preventing circumvention thereof, the Commission is authorized—

(1) to prescribe by order the account or accounts in which particular outlays, receipts, expenses, income, profits, losses, depreciation, appreciation, dividend distributions, and other transactions shall be entered, charged, or credited, and the manner in which any such entry, charge, or credit shall be made;

(2) to require by order that an entry be modified or supplemented;

(3) to prohibit, by rules and regulations or order, the keeping of accounting records other than those prescribed or approved by the Commission, or the keeping of such records in a manner other than those prescribed or approved by the Commission.

(f) No rule, regulation, or order shall be issued under this section prohibiting a person from subclassifying an account, or from maintaining supplementary records reflecting subclassifications of an account, in any manner which does not impair the integrity of the account subclassified.

ACCOUNTANTS AND AUDITORS

SEC. 32. (a) After one year from the effective date of this title, it shall be unlawful for any registered management investment company to file with the Commission any financial statement signed or certified or based upon an examination or audit by any independent public accountant, unless such accountant was selected by vote of the holders of such company's voting securities at the annual

or a special meeting of such security holders duly called; except that any vacancy between such meetings may be filled by the board of directors of such company.

(b) No registered management investment company or registered face-amount certificate company shall file with the Commission any financial statement in the preparation of which the principal accounting officer or employee of such company participated, unless such officer or employee was selected, either by vote of the holders of such company's voting securities at the last annual meeting of such security holders, or by the board of directors of such company.

(c) The Commission is authorized, by rules and regulations or order in the public interest or for the protection of investors—

(1) to prescribe the minimum scope of and procedures to be followed in any audit of a registered investment company; and

(2) to require accountants and auditors to keep reports, work sheets, and other documents and papers relating to registered investment companies and to make the same available for inspection by the Commission or any member or representative thereof.

SETTLEMENT OF CIVIL ACTIONS

SEC. 33. (a) It shall be unlawful for any registered investment company or affiliated person thereof to settle or compromise any claim of the following classes, unless such claim is the subject of a civil action or suit in a court having jurisdiction to approve such settlement or compromise:

(1) any claim by a registered investment company or a security holder thereof against an officer, director, manager, trustee, or depositor of such company for an alleged breach of official duty; or

(2) any claim by a security holder of a registered investment company against such company or an officer, director, manager, trustee, or depositor thereof for an alleged injury done such security holder together with other security holders of the same class.

(b) Whenever any claim of the classes enumerated in subsection (a) is made the subject of a civil action or suit in a court of the United States, such court shall not approve any proposed settlement or compromise of such action or suit, or permit confession of judgment therein without trial, until after the Commission has filed with the court a report concerning the fairness of the proposed settlement, compromise, or confession of judgment, or has notified the court that it will not file a report, or until the expiration of such reasonable time for the filing of a report as the court has fixed, whichever first occurs. A report of the Commission under this section may treat, among other things, of the reasonableness of any legal or other fees to be paid by any registered investment company, in connection with such action or suit, for services rendered a party or parties other than such company.

(c) The Commission is authorized, at the request of any court of a State to which such a proposed settlement, compromise, or confession of judgment has been submitted, to file such a report with such court.

(d) Every report filed pursuant to this section shall be based upon facts established before the court or an officer thereof, or before a member or officer of the Commission pursuant to an investigation by the Commission, and shall be advisory only.

DESTRUCTION AND FALSIFICATION OF REPORTS AND RECORDS

SEC. 34. (a) It shall be unlawful for any person, except as permitted by rule, regulation, or order of the Commission, to destroy, mutilate, or alter any account, cost-accounting procedure, correspondence, memorandum, book, paper, or other record kept pursuant to this title.

(b) It shall be unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed, transmitted, or kept pursuant to this title. It shall be unlawful for any person filing, transmitting, or keeping any such document pursuant to this title to omit to state therein any fact necessary in order to prevent the statements made therein from being materially misleading. For the purposes of this subsection, any part of any such document which is signed or certified by an accountant or auditor in his capacity as such shall be deemed to be made, filed, transmitted, or kept by such accountant or auditor, as well as by the person filing, transmitting, or keeping the complete document.

UNLAWFUL REPRESENTATIONS AND NAMES

SEC. 25. (a) It shall be unlawful for any person in issuing, selling, or offering for sale any security of which a registered investment company is the issuer, to represent or imply in any manner whatsoever that such security or company, or any affiliated person of or principal underwriter for such company, has been guaranteed, sponsored, recommended, or approved by the United States or any agency or officer thereof.

(b) It shall be unlawful for any person registered under any section of this title to represent or imply in any manner whatsoever that such person has been sponsored, recommended, or approved, or that his abilities or qualifications have in any respect been passed upon by the United States or any agency or officer thereof.

(c) No provision of subsection (a) or (b) shall be construed to prohibit a statement that a person or security is registered under this Act, the Securities Act of 1933, or the Securities Exchange Act of 1934, if such statement is true in fact and if the effect of such registration is not misrepresented.

(d) It shall be unlawful for any registered investment company, as part of the name or title of such company or of any security of which it is the issuer, to use any word or words which, in the light of the business and history of such company the Commission finds and by order declares to be deceptive or misleading.

RULES, REGULATIONS, AND ORDERS; GENERAL POWERS OF COMMISSION

SEC. 36. (a) The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as it finds necessary or appropriate to carry out the provisions of this title, including rules and regulations defining accounting, technical, and trade terms used in this title, classifying investment companies and other persons to whom this title relates, and prescribing the form or forms in which information required in registration statements, applications, reports, and other documents filed with the Commission shall be set forth.

(b) The Commission, by such rules and regulations or order as it deems necessary or appropriate in the public interest or for the protection of investors or consumers, may authorize the filing of any information or documents required to be filed with the Commission under this title, the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, or the Trust Indenture Act of 1939, by incorporating by reference any information or documents theretofore or concurrently filed with the Commission under this title or any of such Acts.

(c) No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or order of the Commission, notwithstanding that such rule, regulation, or order may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

HEARINGS BY COMMISSION

SEC. 37. Hearings may be public and may be held before the Commission, any member of members thereof, or any officer of officers of the Commission designated by it, and appropriate records thereof shall be kept. In any proceeding before the Commission, the Commission, in accordance with such rules and regulations as it may prescribe, shall admit as a party any interested State or State agency, and may admit as a party any representative of interested security holders, or any other person whose participation in the proceeding may be in the public interest or for the protection of investors.

ENFORCEMENT OF TITLE; INVESTIGATIONS

SEC. 38. (a) The Commission, in its discretion, may investigate any facts, conditions, practices, or matters which it may deem necessary or appropriate to determine whether any person has violated or is about to violate any provision of this title or any rule or regulations thereunder, or to aid in the enforcement of the provisions of this title, in the prescribing of such rules and regulations thereunder, or in obtaining information to serve as a basis for recommending further legislation concerning the matters to which this title relates. The Commission may require or permit any person to file with it a statement in writing, under oath or otherwise as it shall determine, as to any or all facts and circumstances concerning a matter which may be the subject of investigation. The Commission, in its discretion, may publish information concerning any of the foregoing matters.

(b) For the purpose of any investigation or any other proceeding under this title, including any examination pursuant to section 31, any member of the Commission, or any officer thereof designated by it, is empowered to administer oaths and affirmations, subpena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, contracts, agreements, or other records which are relevant or material to the inquiry. Such attendance of witnesses and the production of any such records may be required from any place in any State or in any Territory or other place subject to the jurisdiction of the United States at any designated place of hearing.

(c) In case of contumacy by, or refusal to obey a subpena issued to, any person, the Commission may invoke the aid of any court of the United States within the jurisdiction of which such investigation or proceeding is carried on, or where such person resides or carries on business, in requiring the attendance and testimony of witnesses and the production of books, papers, correspondence, memoranda, contracts, agreements, and other records. And such court may issue an order requiring such person to appear before the Commission or member or officer designated by the Commission, there to produce records, if so ordered, or to give testimony touching the matter under investigation or in question; and any failure to obey such order of the court may be punished by such court as a contempt thereof. All process in any such case may be served in the judicial district whereof such person is an inhabitant or wherever he may be found. Any person who without just cause shall fail or refuse to attend and testify or to answer any lawful inquiry or to produce books, papers, correspondence, memoranda, contracts, agreements, or other records, if in his or its power so to do, in obedience to the subpena of the Commission, shall be guilty of a misdemeanor, and upon conviction shall be subject to a fine of not more than $1,000 or to imprisonment for a term of not more than one year, or both.

(d) No person shall be excused from attending and testifying or from producing books, papers, correspondence, memoranda, contracts, agreements, or other records and documents before the Commission, or in obedience to the subpena of the Commission or any member thereof or any officer designated by it, or in any cause or proceeding instituted by the Commission, on the ground that the testimony or evidence, documentary or otherwise, required of him may tend to incriminate him or subject him to a penalty or forfeiture; but no individual shall be prosecuted or subject to any penalty or forfeiture for or on account of any transaction, matter, or thing concerning which he is compelled to testify or produce evidence, documentary or otherwise, after having claimed his privilege against self-incrimination, except that such individual so testifying shall not be exempt from prosecution and punishment for perjury committed in so testifying.

(e) Whenever it shall appear to the Commission that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this title, or of any rule, regulation, or order hereunder, it may in its discretion bring an action in the proper district court of the United States, the Supreme Court of the District of Columbia, or the United States courts of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices and to enforce compliance with this title or any rule, regulation, or order hereunder. Upon a showing that such person has engaged or is about to engage in any such act or practice, a permanent or temporary injunction or decree or restraining order shall be granted without bond. In any proceeding under this subsection to enforce compliance with section 7, the court as a court of equity may, to the extent it deems necessary or appropriate, take exclusive jurisdiction and possession of the investment company or companies involved and the books, records, and assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, who with the approval of the court shall have power to dispose of any or all of such assets and, subject to such terms and conditions as the court may prescribe, may make such disposition in accordance with a plan of reorganization as to which a declaration is effective under section 25. The Commission may transmit such evidence as may be available concerning any violation of the provisions of this title, or of any rule, regulation, or order thereunder, to the Attorney General, who, in his discretion, may institute the appropriate criminal proceedings under this title.

COURT REVIEW OF ORDERS

SEC. 39. The provisions of section 24 of the Public Utility Holding Company Act of 1935 are hereby incorporated in this title as though fully set forth herein.

JURISDICTION OF OFFENSES AND SUITS

SEC. 40. (a) The provisions of section 25 of the Public Utility Holding Company Act of 1935 are hereby incorporated in this title as though fully set forth herein.

(b) Any criminal proceeding based upon a violation of section 34, or upon a failure to file a report or other document required to be filed under this title, may be brought in the district wherein the defendant is an inhabitant or maintains his or its principal office or place of business.

INFORMATION FILED WITH COMMISSION

SEC. 41. (a) The information contained in any registration statement, application, report, or other document filed with the Commission pursuant to any provision of this title or of any rule or regulation thereunder shall be made available to the public, unless and except insofar as the Commission, by rules and regulations upon its own motion, or by order upon application, finds that public disclosure is neither necessary nor appropriate in the public interest or for the protection of investors. It shall be unlawful for any member, officer, or employee of the Commission to use for personal benefit, or to disclose to any person other than an official or employee of the United States or of a State, for official use, any information contained in any document so filed, if such information is not available to the public.

(b) Photostatic or other copies of information contained in documents filed with the Commission under this title and made available to the public shall be furnished any person at such reasonable charge and under such reasonable limitations as the Commission shall prescribe.

ANNUAL REPORTS OF COMMISSION; VALIDITY OF CONTRACTS; LIABILITY OF CONTROLLING PERSONS; PREVENTING COMPLIANCE WITH TITLE; EMPLOYEES OF THE COMMISSION

SEC. 42. The provisions of sections 23, 26, 27, and 31 of the Public Utility Holding Company Act of 1935 are hereby incorporated in this title as though fully set forth herein.

PENALTIES

SEC. 43. Any person who willfully violates any provision of this title or of any rule, regulation, or order hereunder shall upon conviction be fined not more than $10,000 or imprisoned not more than two years, or both; but no person shall be convicted under this section for the violation of any rule, regulation, or order if he proves that he had no knowledge of such rule, regulation, or order.

EFFECT ON EXISTING LAW

SEC. 44. Except where specific provision is made to the contrary, nothing in this title shall affect (1) the jurisdiction of the Commission under the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, or the Trust Indenture Act of 1939, over any person, security, or transaction, or (2) the rights, obligations, duties, or liabilities of any person under such Acts; nor shall anything in this title affect the jurisdiction of any other commission, board, agency, or officer of the United States or of any State or political subdivision of any State, over any person, security, or transaction, insofar as such jurisdiction does not conflict with any provision of this title or of any rule, regulation, or order hereunder.

GENERAL DEFINITION

SEC. 45. (a) When used in this title, unless the context otherwise requires—

(1) "Person" means a natural person or a company.

(2) "Company" means a corporation, a partnership, an association, a joint-stock company, a trust, or any organized group of persons whether incorporated or not; or any receiver, trustee in bankruptcy, or similar official or any liquidating agent for any of the foregoing ,in his capacity as such.

(3) "Security", "prospectus", and "underwriter" have the same meanings as in the Securities Act of 1933.

(4) "Exchange", "facility" (when used with respect to an exchange), "broker", "dealer", "bank", "director", "State", and "interstate commerce" have the same meanings as in the Securities Exchange Act of 1934.

(5) "Voting security" means any security presently entitling the owner or holder thereof to vote in the direction or management of the affairs of a company. A specified percentage of the outstanding voting securities of a company means such amount of its outstanding voting securities as entitles the holder or holders thereof to cast said specified percentage of the aggregate votes which the holders of all the outstanding voting securities of such company are entitled to cast. The vote of a majority of the outstanding voting securities of a company means the vote, at the annual or a special meeting of the security holders of such company duly called, (A) of 67 per centum or more of the voting securities present at such meeting, if more than 50 per centum of the outstanding voting securities of such company are present; or (B) or more than 50 per centum of the outstanding voting securities of such company.

(6) "Senior security" means a security, other than short-term paper, which is entitled to a preference in its distribution of assets over another security of the same issuer.

(7) "Redeemable security" means any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.

(8) "Face-amount certificate" means any certificate, investment contract, or other security which represents an obligation on the part of its issuer to pay a stated or determinable sum or sums at a fixed or determinable date or dates, in consideration of the payment of a sum certain or of periodic installments of a stated or determinable amount.

(9) "Periodic payment plan certificate" means any certificate, investment contract, or other security providing for a series of periodic payments by the holder, and representing an undivided interest in certain specified securities or in a unit or fund of securities purchased wholly or partly with the proceeds of such payments.

(10) "Short-term paper" means any note, draft, bill of exchange, or banker's acceptance payable on demand or having a maturity at the time of isssuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof payable on demand or having a maturity likewise limited; and such other classes of securities, of a commercial rather than an investment character, as the Commission may designate by rules and regulations.

(11) "Government security" means any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing.

(12) "Marketable security" means any security which is listed or admitted to unlisted trading privileges on a national securities exchange or on an exchange exempted from registration pursuant to section 5 of the Securities Exchange Act of 1934, or for which a market price is regularly ascertainable from publications or other readily accessible sources.

(13) "Issuer" means every person who issues or proposes to issue any security, or has outstanding any security which it has issued.

(14) "Principal underwriter" means any underwriter who, in connection with a primary distribution of securities, (A) is in privity of contract with the issuer or an affiliated person of the issuer; (B) acting alone or in concert with one or more other persons, initiates or directs the formation of an underwriting syndicate; or (C) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

(15) "Investment officer" means any officer of an investment company who is empowered to execute or order the execution of purchases or sales of securities for the account of such conmpany.

(16) "Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) the publisher of any bona fide newspaper or newsmagazine of general circulation; or (D) such other persons, not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

(17) "Manager" of an investment company means a person empowered by contract or otherwise to determine what securities and other investments shall be

purchased or sold by such company; but does not include (A) a bona fide officer, director, trustee, depositor, or employee of such company in his capacity as such; (B) an investment adviser each of whose recommendations for purchase or sale must be approved, before such purchase or sale is executed, by an investment officer, director, or trustee of such company who is not an affiliated person of such investment adviser; or (C) any person the character and amount of whose compensation from such company must be approved by a court.

(18) "Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, or copartner of such other person; (E) if such other person is an investment company, any manager thereof or any person who regularly acts as investment adviser thereof; and (F) if such other person is a unit investment trust, the depositor thereof.

(19) "Affiliated company" means, a company which is an affiliated person.

(20) "Majority-owned subsidiary" of a person means a company 50 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a majority-owned subsidiary of such person.

(21) "Wholly-owned subsidiary" of a person means a company 95 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a wholly-owned subsidiary of such person.

(22) "Investment company system" means two or more investment companies one of which through its ownership of voting securities directly or indirectly controls the others.

(23) "Insurance company" means a company which is organized as an insurance company under the laws of a State, whose primary and predominant business activity is the writing of insurance, and which is subject to supervision by the insurance commissioner or a similar official or agency of such State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such.

(24) "Employees' securities company" means any investment company or similar issuer all of the outstanding securities of which (other than short-term paper) are owned (A) by the employees of a single employer or of two or more employers each of which is an affiliated company of the other, (B) by former employees of such employer or employers, (C) by members of the immediate family of such employees or former employees, (D) by any two or more of the foregoing classes of persons, or (E) by such employer or employers together with any one or more of the foregoing classes of persons.

(25) "Sale", "sell", "offer to sell", or "offer for sale" includes every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been sold for value.

(26) "Sales load" means the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer, or in the case of a unit investment trust, by the depositor or trustee. In the case of a periodic payment plan certificate, "sales load" includes the sales load on any investment company securities in which the payments made on such certificate ore invested, as well as the sales load on the certificate itself.

(27) "Lend" includes a purchase coupled with an agreement by the vendor to repurchase; "borrow" includes a sale coupled with a similar agreement.

(28) "Assignment" includes any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but does not include an assignment of partnership interests incidental to the death or withdrawal of a minority of the members of the partnership having only a minority interest in the partnership business.

(29) "Value", as used in sections 3, 5, and 12, means (A) with respect to marketable securities acquired before the end of the owner's last fiscal quarter, the market value of such securities at the end of such fiscal quarter, and (B) with respect to other assets (including other securities), the cost thereof to the owner, or if the

Commission finds that such cost is not ascertainable without undue effort or expense or does not fairly reflect the value thereof, a valuation on such other reasonable basis as the Commission may prescribe by rules and regulations or order. As used elsewhere in this title, the term "value" or any other term importing value means the valuation given in, or a valuation based on the accounting principles followed in, the most recent registration statement or periodic report filed under this title by the company concerned.

(30) "Portfolio turnover" means the ratio which the sum of the dollar amount of a company's sales and purchases of portfolio securities (other than Government securities) during a given fiscal year, minus the dollar amount of net sales during the same year of securities of which such company is the issuer, bears to the value of such company's security assets (exclusive of Government securities) at the beginning of such year or at the end of any quarter thereof, whichever is the highest.

(31) "Convicted" includes a verdict, judgment, or plea of guilty, or a finding of guilt on a plea of nolo contendere, if such verdict, judgment, plea, or finding has not been reversed, set aside, or withdrawn, whether or not sentence has been imposed.

(32) "National securities exchange" means an exchange registered under section 6 of the Securities Exchange Act of 1934.

(33) "Means or instrumentality of interstate commerce" includes any facility of a national securities exchange.

(34) "Commission" means the Securities and Exchange Commission.

(35) "Securities Act of 1933", "Securities Exchange Act of 1934", "Public Utility Holding Company Act of 1935", and "Trust Indenture Act of 1939" mean those Acts, respectively, as heretofore or hereafter amended.

(b) No provision in this title shall apply to, or be deemed to include, the United States, a State, or any political subdivision of a State, or any agency, authority, or instrumentality of any one or more of the foregoing, or any corporation which is wholly owned directly or indirectly by any one or more of the foregoing, or any officer, agent, or employee of any of the foregoing acting as such in the course of his official duty, unless such provision makes specific reference thereto.

SEPARABILITY OF PROVISIONS

SEC. 46. If any provision of this title or any provision incorporated in this title by reference, or the application of any such provision to any person or circumstances, shall be held invalid, the remainder of this title and the application of any such provision to persons or circumstances other than those as to which it is held invalid shall not be affected thereby.

SHORT TITLE

SEC. 47. This title may be cited as the "Investment Company Act of 1940."

EFFECTIVE DATE

SEC. 48. The effective date of this title is October 1, 1940. Except where specific provision is made to the contrary, every provision of this title shall take effect on said effective date.

TITLE II—INVESTMENT ADVISERS

FINDINGS OF THE CONGRESS

SEC. 201. Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby found that investment advisers are of national concern, in that, among other things—

(1) their advice, counsel, publications, writings, analyses, and reports are customarily furnished and distributed, and their contracts, subscription agreements, and other arrangements with clients are customarily negotiated and performed, by the use of the mails and means and instrumentalities of interstate commerce;

(2) their advice, counsel, publications, writings, analyses, and reports customarily relate to securities, and to the volume of trading in and the prices

of securities, which are traded on national securities exchanges and in interstate over-the-counter markets, securities issued by companies engaged in business in interstate commerce, and securities issued by national banks and member banks of the Federal Reserve System;

(3) they advise and through such advice influence the policies of large financial and other institutions engaged in banking and in interstate business; and

(4) all of the foregoing transactions are carried on in such great volume as substantially to affect interstate commerce, national securities exchanges, and other securities markets, the national banking and monetary system and the entire national economy.

DECLARATION OF POLICY

SEC. 202. Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

(1) when investors are unable to obtain adequate information as to the activities, practices, ability, training, and integrity of investment advisers, their affiliated persons, and employees;

(2) when persons of proven lack of integrity in financial matters are permitted to engage in business as investment advisers;

(3) when the compensation of investment advisers is based upon profit-sharing contracts and other contingent arrangements conducive to excessive speculation and trading; or

(4) when the business of investment advisers is so conducted as to defraud or mislead investors, or to enable such advisers to relieve themselves of their fiduciary obligations to their clients.

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is presently practicable to eliminate the abuses enumerated in this section.

APPLICATION OF TITLE I

SEC. 203. The provisions of the following sections of title I are hereby incorporated in this title as though fully set forth herein: Sections 3, 34 (b), 35 (b) and (c), 36, 37 (e) and (f), 38, 39, 40, 41, 42, 43, 45, 46, and 47.

REGISTRATION OF INVESTMENT ADVISERS

SEC. 204. (a) Except as provided in subsection (b), it shall be unlawful for any investment adviser, unless registered under this section, to make use of the mails or any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser.

(b) The provisions of subsection (a) shall rot apply to an investment adviser—

(1) all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business;

(2) who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on a national securities exchange; and

(3) who does not furnish advice or issue analyses or reports with respect to securities for which an over-the-counter market exists in any State other than that within which such investment adviser maintains his or its principal office or place of business.

(c) Any investment adviser, or any person who presently contemplates becoming an investment adviser, may register under this section by filing with the Commission an application for registration. Such application shall contain such of the following information and documents, in such form and detail as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors:

(1) information in respect of—

(A) the organization and personnel of such investment adviser, including the number of his or its employees and their duties;

(B) the eduation, experience, and other background, and the past and present business affiliations of such investment adviser;

(C) the nature and scope of the business of, and of the advice, analyses, and reports furnished by, such investment adviser;

(D) the nature and scope of the authority and practices of such investment adviser with respect to clients' funds and accounts; and

(E) the basis or bases upon which such investment adviser, his or its partners, officers, directors, and employees are compensated;

(2) copies of every form of contract or agreement between such investment adviser and its clients which is regularly used by such investment adviser; and

(3) such further information and copies of such further documents relating to such investment adviser, his or its affiliated persons and employees as the Commission may by rules and regulations or order prescribe as necessary or appropriate in the public interest or for the protection of investors.

Except as hereinafter provided, such registration shall become effective thirty days after receipt of such application by the Commission, or within such shorter period of time as the Commission may determine. Any amendment of an application filed not more than fifteen days after the filing of such application shall be deemed to have been filed with and as a part of such application. Any amendment of an application filed more than fifteen days after the filing of such application shall be deemed a new application incorporating by reference the unamended items of the earlier application.

(d) The Commission shall by order deny registration to or revoke or suspend the registration of an applicant under this section, if the Commission finds that such denial, revocation, or suspension is in the public interest and that such investment adviser or any partner, officer, director, or controlling person thereof—

(1) within ten years of the issuance of such order, has been convicted of any felony or misdemeanor involving the purchase or sale of any security or arising out of any conduct or practice of such investment adviser or affiliated person as an investment adviser, underwriter, broker, or dealer, or as an affiliated person or employee of any investment company, bank, or insurance company;

(2) at the time of the issuance of such order, is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, or dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security;

(3) has omitted to state in such application or in an amendment thereto any fact which such person is required to state therein; or

(4) has willfully violated section 34 (b) of title I of this Act, or that portion of section 203 of this title which incorporates the provisions of said section 34 (b).

(e) The commencement of a proceeding to deny registration under this section shall operate to postpone the effective date of registration pending final determination of such proceeding.

(f) Any person registered under this section may, upon such terms and conditions as the Commission finds necessary in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any person registered under this section, or who has pending an application for registration filed under this section, is no longer in business or is not engaged in business as an investment adviser, the Commission shall by order cancel the registration of such person.

INVESTMENT ADVISORY CONTRACTS

Sec. 205. No investment adviser registered under section 204 shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to enter into, extend, or renew any investment advisory contract, or in any way to perform any investment advisory contract entered into, extended, or renewed on or after the effective date of this title, if such contract—

(1) provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client; or

(2) fails to provide, in substance, that no assignment of such contract shall be made by the investment adviser.

As used in this section, "investment advisory contract" means any contract or agreement whereby a person agrees to act as investment adviser or to manage any investment or trading account for another person. Paragraph (1) of this section shall not be construed to prohibit an investment advisory contract which provides for compensation based upon the total value of a fund averaged over a definite period or taken as of a definite date.

PROHIBITED TRANSACTIONS BY REGISTERED INVESTMENT ADVISERS

SEC. 206. It shall be unlawful for any investment adviser registered under section 204, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon any client or prospective client;

(3) acting as principal, knowingly to sell any security to or purchase any security from any client, unless such investment adviser is a member of an association of brokers or dealers registered with the Commission pursuant to section 15A of the Securities Exchange Act of 1934; or

(4) if such investment adviser is a member of such an association, knowingly to sell any security to or purchase any security from any client without disclosing to such client in writing at or before the completion of such sale or purchase whether he is acting as a dealer for his own account, as a broker for such customer, or as a broker for some other person.

PENALTIES

SEC. 207. Any person who willfully violates any provision of this title shall upon conviction be fined not more than $10,000 or imprisoned not more than two years, or both.

SHORT TITLE

SEC. 208. This title may be cited as the "Investment Advisers Act of 1940".

EFFECTIVE DATE

SEC. 209. This title shall become effective on October 1, 1940.

Senator WAGNER (chairman of the subcommittee). The first witness before the subcommittee will be Judge Robert E. Healy, Commissioner of the Securities and Exchange Commission. Judge Healy, are you prepared to proceed?

Mr. HEALY. Yes; Mr. Chairman.

STATEMENT OF ROBERT E. HEALY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Senator WAGNER. Judge Healy, would you rather proceed with your prepared statement and then have the members of the subcommittee propound such questions as they may desire? Or what is your preference in that regard?

Mr. HEALY. If it is left to my preference I think it would be better if I might go ahead and make my statement, and thereafter submit to such questions as the members of the subcommittee may wish to ask me.

Senator WAGNER. That will be all right. You may proceed.

Senator TOWNSEND. Judge Healy, may I state at this time that when I have to leave, about 5 minutes to 11 o'clock, I am not running out on you, but have to go to attend a meeting of a subcommittee of the Committee on Appropriations, of which I am a member.

Senator MALONEY. And I would like to state that I have to go to a meeting of the Commerce Committee, but I hope to get back in a short time. But, as you doubtless know, that is the way we live up here.

Senator DOWNEY. I can stay with you throughout.

Mr. HEALY. I am sorry that all of you gentlemen cannot remain, but we have to do the best we can.

Senator WAGNER. Every member of this subcommittee will rely upon reading the testimony when we get into a general discussion of the bill.

Mr. HEALY. I will leave with the subcommittee some copies of my prepared statement.

Senator WAGNER. Do you say you have copies for the members of the subcommittee?

Mr. HEALY. Yes.

Senator WAGNER. May we have them now?

Mr. HEALY. Here they are.

Senator WAGNER (chairman of the subcommittee). We will now proceed with the hearing. I hope everyone present will try to be as quiet as possible. I always dislike to be a disciplinarian but it is very difficult for the members of the subcommittee to hear a witness unless we have reasonable quiet in the room.

All right, Judge Healy, you may proceed. And will you speak out as loudly as may be necessary. I am sure the number of spectators present are interested in the proceedings and would like to hear your testimony.

Mr. HEALY. Mr. Chairman and Senators, my name is Robert E. Healy. I am a member of the Securities and Exchange Commission. I have had general supervision of the Commission's study of investment trusts and investment companies. I am here in behalf of the bill as a representative of the Commission, which endorses the bill and recommends to the Congress that it be adopted at the present session.

In 1935, when the Congress passed the Public Utility Holding Company Act, it included in it section 30, which not only authorized, but directed, the Securities and Exchange Commission to make a study of investment trusts and investment companies, and to report its findings and recommendations to the Congress. The members of the staff and I will attempt to outline in some detail the results of our 4-year survey of the industry, made pursuant to this mandate.

Let me try my hand at a general description of investment trusts and investment companies. Essentially these organizations are large liquid pools of the public's savings entrusted to managements to be invested. The sales and promotional literature of investment trusts and investment companies has created the impression that they are not unlike savings banks and insurance companies, except that they are not limited to so-called legal investments. The sales emphasis by promoters of investment companies has been upon the necessity for providing security for old age and for emergencies, and upon the claim that by expert management and diversification of risk, this security can be furnished by these organizations.

For example, Charles A. Kettering, vice president and research director of General Motors Corporation (and I pause to say, one of our most useful and finest citizens), testified at the public examination

that in 1930 he purchased 40,000 shares of an investment company for $260,000 in the belief that it gave him a participation in a wide range of securities and was "akin or about the same participation you would get in, say, one of these single payment life insurance companies." He said that he did not know that investment companies were not subject to supervision as were life insurance companies or banks. Ultimately Mr. Kettering realized only $20,000 on his investment—that is, he lost approximately a quarter of a million dollars. And, incidentally, I may add that he served as a director of that company; said he had been unable to attend meetings, and said he did not understand investments; adding, what interested me greatly, that he saw life through the laboratory window.

The interest of the public in investment trusts and investment companies has been and still is very large.

In the last 15 years approximately 1,300 such companies have been created. Speaking generally these organizations have made comparatively little original contribution of capital to industry, the investments for the most part being in securities already issued and outstanding. The reason for that I think will appear before the hearings are over. It is due, in part, to the necessity of some companies keeping themselves in a strictly liquid position. The American public, has contributed over $7,000,000,000 to these organizations. That is on the basis of investment. You can compare that with $14,000,000,000 roughly estimated as the investment in the electric light industry. The value of their assets at present is approximately $4,000,000,000. At present only some 650 or approximately one-half of investment companies formed in this country, are still in existence. The other companies have disappeared through bankruptcy, receivership, dissolution, mergers, and consolidations. With respect to 22 of the bankrupt companies upon which the Commission has reasonably accurate figures, the security holders sustained a capital loss to December 31, 1935, of approximately $510,000,000 out of a total net capital contribution of almost $560,000,000, or a loss of about 90 percent. Altogether investors have sustained a capital shrinkage of approximately $3,000,000,000 in all types of investment trusts and investment companies.

Many individual investment companies have total assets equal to those of the larger savings banks. Their securities are owned by approximately 2,000,000 investors throughout this country, with the majority of the individual investments in such securities having a value of under $500. The number of security holders of investment trusts and companies probably exceeds that of all other industries except utility holding company systems. It is estimated that one out of every 10 holders of securities of all types in this country is a holder of investment trust and investment company shares or certificates.

In addition, investment companies at present control or are in a position to control or importantly influence various industrial, banking, utility, and other enterprises having total assets which, as of the end of 1935, amounted to some $30,000,000,000. Furthermore, these investment trusts and investment companies, because of their very substantial trading in securities on stock exchanges, are a most substantial factor in our securities markets.

Because of the large public interest in these organizations, and because these investment trusts and investment companies represent

unsupervised pools of savings, these institutions have been a matter of concern to representatives of the investment company industry, stock exchanges, financial writers, and governmental bodies from the early period of their existence in this country. The potential dangers of these organizations have been indicated and with the passing years criticism has increased.

In the year 1928, for example, the attorney general of the State of New York conducted an investigation of investment trusts. He recommended that investment trusts be required to incorporate under the banking laws and be subject to the supervision of the State banking superintendent. His recommendation was not adopted, I might say.

In March 1929 Paul Cabot, who has been associated with the State Street Investment Corporation since its inception, in an article in "The Atlantic Monthly", predicted that, unless promoters in the United States avoided the "errors of false principles" committed in the early history of investment trusts in England—

* * * we (in the United States) shall inevitably go through a similar period of disaster and disgrace.

[I think his prediction has been realized]. In the opinion of Mr. Cabot, the two major abuses of the industry were: (1) the companies were being operated primarily to serve the self-interest of the sponsors rather than the best interests of shareholders; (2) investment companies were being used as receptacles for otherwise unmarketable securities, [dumping grounds, in other words.] The author stated that he had testified before a committee of the New York Stock Exchange that the common and general abuses of the investment trust promoters and managers can be traced to "dishonesty", "inattention", "inability", and "greed", and cited various illustrations in support of his contention.

Prior to June 1929, the New York Stock Exchange did not list the securities of investment trusts or investment companies. The reasons which prompted the Exchange generally to deny such listing were not specifically expressed in any rules or regulations or public statements. However, one of the members of the New York Stock Exchange who, in the early 1920's, had discussed with the Exchange officials the prospect of forming and listing an investment company, stated that the Exchange felt that these organizations were "blind pools".

The New York Stock Exchange apparently was substantially concerned with the problems of investment trusts even after their securities were admitted to listing. In 1931, the Exchange adopted some tentative requirements with respect to listing the securities of these companies, stating:

It has been urged that the public interest in investment trusts is entitled to adequate representation on directorates, and that such independent representation should be had through qualified individuals not directly affiliated either with the management of the trust itself or with its banking sponsors, if any.

I want to emphasize that recommendation of the exchange because this is a matter which will be referred to later, when the bill comes up for discussion. Now, continuing the quotation from the statement of the Exchange:

It is felt that, in default of such representation, the possibility of questionable transactions between investment trusts and their banking sponsors exists; and

that this danger may lead to the feeling that investment trusts are not always managed with an eye single to the interests of their own stockholders.

Against any such suspicion, investment trusts should be protected, and this protection will in the long run prove a benefit not only to the public but to the trusts themselves, and the banking houses with which they are at times identified.

It appears to the committee as if such protection could be most readily obtained by independent directors under whose scrutiny and friendly criticism contemplated transactions would pass for review.

This view will weigh with the committee in considering listing applications.

This committee (Banking and Currency Committee of Senate), in June 1934 in its report on stock exchange practices, discussed investment trusts and investment companies and said:

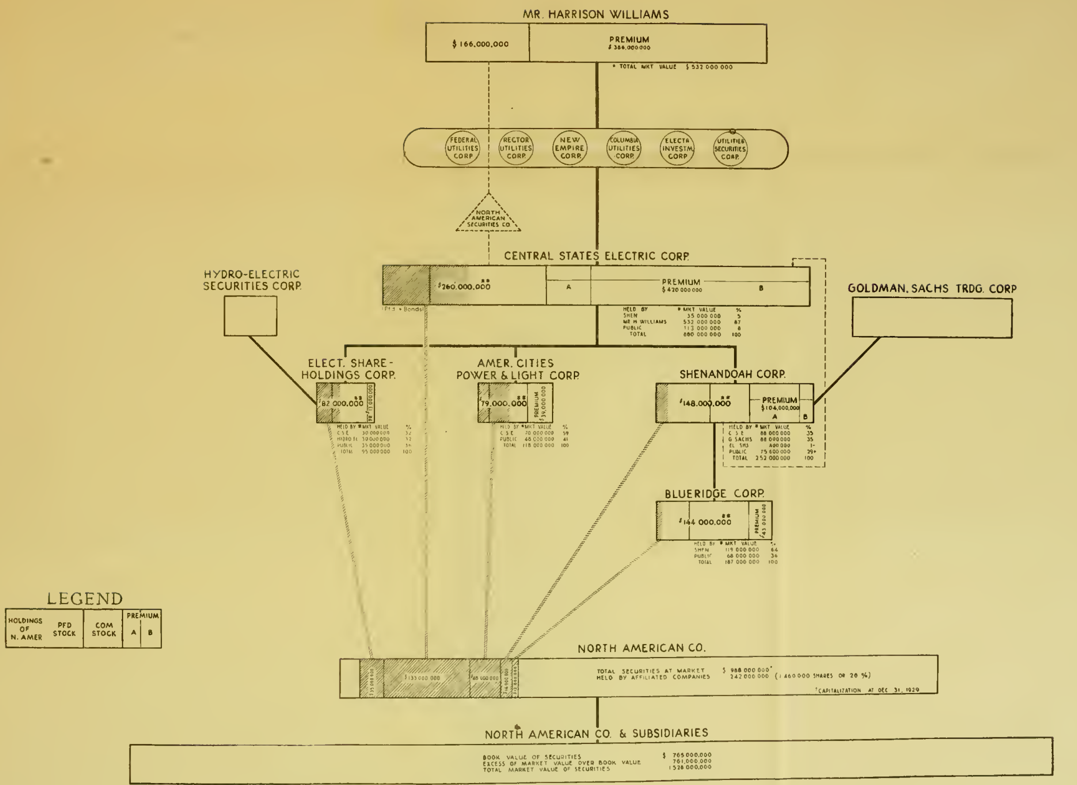
The facility of perverted uses of these companies requires that these trusts be circumscribed with protective safeguards. The record indicates that it may be necessary to simplify the capital structures of investment trusts to prevent the organizers from usurping control and a disproportionate part of the equity and yield of these trusts; to limit and prescribe the concentration of securities in a particular industry; to prevent the diversion of these trusts from their normal channels of diversified investment to the abnormal avenues of control of industry; to prohibit pyramiding of investment trusts; to completely divorce investment trusts from investment banking; to eliminate the conflict of interest between investment managers and the public; to compel full and complete disclosure of the organization, capital structure, and management of the conduct of investment trusts.

And finally, in 1935, as the culmination of this interest and these misgivings concerning the operation of investment companies, the Congress directed the S. E. C., in section 30 of the Public Utility Holding Company Act, to make the study on which I am now reporting. The inclusion of this provision in a statute dealing with public utility holding companies suggests that Congress was moved, not alone by the considerations referred to in the 1934 report of this committee, but also by the suspicion that there might exist upstairs, above the utility holding companies, various investment trusts which had not been examined by the Federal Trade Commission or the committees of Congress. As will appear later, these suspicions were well founded. There are a number of these investment trusts which were rather intimately connected with holding companies in the public utility field. [When the Federal Trade Commission reported on the North American Co. the picture painted, depicting it from the North American Co. down through the subsidiaries, was not at all as bad as it was found to be in the case of many other holding companies. The investment trust study, however, has developed some very interesting facts as to what you might call the jungle of companies existing above the North American Co. They are shown on this chart which I now offer for the record.]

Senator WAGNER. The chart will be included in the record along with your testimony.

(The chart is as follows:)

SEPT. 30, 1929



* MKT VALUE CORPORATIVE OUTSTANDING SEC BASED ON MKT PRICE OF THOSE TRADED SEPT 30 1929
** UNDERLYING ASSETS AT MKT AS OF SEPT. 30 1929 TOTAL ASSETS OF AFFILIATED INV. COS. AT ASSET VALUE OTHER SEC. AT MKT
PREMIUM A : EXCESS OF MKT. VALUE OF OUTSTANDING SEC. OF AFFD COS IN PORTFOLIO OVER THEIR ASSET VALUE
PREMIUM B : EXCESS OF MKT VALUE OF OUTSTANDING SEC. OF CORPORATION OVER MKT VALUE OF SEC. IN PORTFOLIO.

D 319 SECURITIES AND EXCHANGE COMMISSION

PREPARED BY THE RESEARCH DIVISION

The study of these companies has been made by the Commission as directed by Congress, and I wish to point out in a general way what the study has disclosed. Before I do this, however, I wish to make it clear that I am not here to say to the committee that all investment trusts and all investment companies are bad, or that all men in the business are untrustworthy. Nor do I want to imply that all the evils and malpractices which we uncovered, and which we will discuss in detail, existed in all types of companies to the same degree or extent, or that some improvement has not been recently attempted by various companies. But I must say, because it is the truth, that, considered as a whole, the record of the industry is shocking. The most pessimistic prophets of the dire consequences to the investor of unregulated investment trusts have been justified.

I shall not now attempt to rehearse the numerous abuses which the study has disclosed. They will be explained to you in some detail later in the hearings. However, on the basis of the record, I am constrained to state that too often investment trusts and investment companies were organized and operated as adjuncts to the business of the sponsors and insiders to advance their personal interest at the expense of and to the detriment of their stockholders. Too often, sponsors and managers and insiders disregarded their basic fiduciary obligation to their investors.

Subordination of the interests of security holders to those of promoters and management takes many forms. I am not speaking merely of the instances of outright embezzlement. I am referring to the unloading of worthless securities and other investments of doubtful value upon the companies; to loans which investment companies have been caused to make to insiders; to the bail-outs of insiders from dubious and illiquid investments, from onerous commitments and from trading accounts. Investment companies have been compelled to finance banking clients of the insiders, and companies in which they were personally interested. Some investment companies are organized to be operated essentially as discretionary brokerage accounts, with the insiders obtaining the brokerage commission. In many instances the abuses are more subtle but just as injurious to the investor. The public's funds are used to further the banking business of the insiders, to obtain control of various industrial enterprises, banks and insurance companies, so that the emoluments of this control will flow to these controlling persons, and otherwise to serve the personal interests of the sponsors and management.

Another flagrant abuse is the organization of investment trusts and companies as manufacturers of securities, so that promoters in the distribution business can sell these securities regardless of the economic soundness of the trusts. Securities have been peddled from door to door like so much merchandise.

Insiders have also engaged in practices which permitted them to obtain large profits without any risk, by trading in the securities issued by the trust, to the pecuniary detriment of their investors. That may sound almost impossible, but representatives of the Registration Division of the Commission I think will prove it to the full satisfaction of this subcommittee. To increase their distribution profits and management fees, these insiders engaged in distribution practices which resulted in substantial dilution of the investors' interests.

To permit these promoters and insiders to accomplish these personal gains and to insure their control of the public funds without the necessity of substantial investment of their own funds, the charters of many of these companies have been so drawn to allow the insiders to deal as principal with these trusts and companies and contain the broadest exculpatory clauses. Complicated capital structures have been devised. Tricky management stocks with disproportionate voting power are issued to insiders. Voting trusts are created. Insiders give themselves long-term management contracts. Boards of directors often consist solely or predominantly of representatives of banking, brokerage, or distributor sponsors.

So too, after investors have invested substantial sums in companies on their faith in the reputation and standing of the existing managements, the insiders have frequently transferred control of the remainder of the public's funds to other persons, without the prior knowledge or consent of these security holders. Trafficking in control of investment trusts has reached surprising proportions. The investor in many instances has been kept in ignorance of these occurrences because of the inadequate or even deceptive character of the companies' reports to their stockholders.

The seriousness of these abuses is intensified by the fact that holders of investment company securities are peculiarly investors in the low-income brackets—the least sophisticated of investors. As I have indicated, during the relatively short period of their existence in this country investment trusts and companies have lost vast sums of money. The persons who paid for these losses constitute a class of investors who could least of all afford them.

These are not the evils and abuses of the past. The fact is that during the very course of the Commission's study some of the worst wrongs were perpetrated. The Commission had one particularly interesting experience. At one of our public examinations two witnesses were describing the manner in which they had depleted the assets of some investment trusts which they had formerly dominated. We later learned that these same individuals almost literally took time off from our public examination in order to complete their arrangements to loot some other investment trusts which had come under their control. I am happy to say that they are under indictment for it.

I am convinced, as is the entire Commission, that unless these companies are supervised they will represent a source of injury to the investor exceeding any social or economic function they may serve. I realize that this is a grave assertion for any man to make about any industry, and I make it in all seriousness.

It should hardly be necessary to point out that existing legislation is not adequate to meet the problems presented by the investment company. The mere recital of the abuses which have occurred since 1933 and 1934, tends to prove that the Securities Act of 1933 and the Securities Exchange Act of 1934, valuable as they are in most fields, are inadequate here. Because of the peculiar character of investment companies and their resemblance to savings banks, mere disclosure is inadequate as a remedy. Indeed, in many instances even publicity has not been achieved, since numerous companies have not found it necessary to register their securities with the Commission under either Act. The disclosure principle embodied in the Securities Act

and Securities Exchange Act is a sound principle, but it has its limitations. Let me quote from a leading editorial which appeared in the New York Times on November 12, 1936:

> Many investment trust officers would stop here, (publicity) holding that 'bright sunlight' is all that is needed, and that once this is brought to bear on trust affairs the investor himself must make his choice. But the experience of the last decade indicates that more than this is needed.
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> Among the principal abuses of investment trusts have been their use as dumping grounds for unmarketable underwritings participated in by the banking house controlling the trusts; the too rapid turning over of their portfolios (often with the object of obtaining commissions for the banking house); a complicated financial structure; the acquisition of highly speculative instead of sound dividend-paying stocks; and the excessive concentration of investments in one or a few companies. Most of these abuses would not be difficult to correct. There are also other practices the wisdom of which, on grounds of public policy, is at least open to debate. These include, for example, the purchase of so large an amount of the stock of particular companies that the trust has a dominating voice in the management of those companies. Investment trusts, in any case, are as properly subject to regulation as savings banks and insurance companies. Such regulation has been long overdue.

The conclusions and recommendations of the Commission are not based on any cursory, haphazard sampling of the industry. Rather the study, at least in my opinion, is a comprehensive and objective survey of all the types of investment trusts and investment companies which exist or have existed in this country.

[As I have stated, from its inception I was given general supervision of the study.] Paul P. Gourrich was made director of the study. (He resigned because of ill health in March 1939.) William H. Spratt, Jr., was made chief of the study and David Schenker was made counsel. We recruited a staff of accountants and men with some experience and training in the investment trust field. Unhappily, Mr. Spratt had to submit to a major surgical operation. He failed to rally from it and died, largely, I believe, as the result of overwork and sticking too long to his post of duty.

We did not complete the study and report within the time mentioned in the statute. In that connection we must accept a reasonable amount of criticism. The fact is, however, by way of explanation and not of excuse, that the size and the problems of the industry proved to be much larger or more complicated than either we or Congress evidently anticipated. Moreover, during the course of the study many changes took place in the industry itself. In addition, when we were nearing the completion of our study, in fact after we had completed our public examinations, several investment companies were literally looted, and we had to reopen our investigation and conduct further hearings.

I would like the members of the subcommittee to know what our methods were in conducting the study: We prepared tentative questionnaires for each of the various types of companies and, as the Senators will see, there are a good many different types. We asked the various branches of the industry to organize committees to consult with us. They did so. We submitted the tentative questionnaires to them and considered all of their suggestions and then put the questionnaires in final form. The industry's committees did not give the questionnaires any formal approval, but they made very little objection to them.

Most of the information and data were accumulated from answers to these questionnaires. By the end of 1937, the Commission had received replies from about 700 trusts and companies of all types and from about 400 investment advisers. In addition, field studies were made of about 60 companies, which has been acquired and absorbed by two large investment companies during the period 1927 to 1935.

In addition to that, we sent accountants and examiners into the field to study the books and records of about 100 companies. Furthermore, we examined various State and court records of about 100 companies. Furthermore, we examined various State and court records to learn what we could about various lawsuits involving trusts and the history of various trusts which had become defunct. All in all, we collected our material from a great variety of sources.

After the examinations in the field and study of the questionnaires the staff prepared a detailed preliminary report on each company. The report was submitted to the company and its representatives were invited to come and talk with the staff about the report; and nearly all of them did so. The result was to promote better understanding of their problems on our side, and also to afford them an opportunity to explain away, in some instances at least, facts which, superficially and unexplained, seemed a good deal more sensational than they turned out to be. However, as the Senators will hear, there was no ultimate scarcity of examples of shocking abuses. These conferences also had the virtue of preparing the companies for public hearing by letting them know what topics they were expected to testify about and what papers and records they were expected to bring.

In general, the next stage was the public examinations, which were held on 250 companies—practically every company which had $10,000,000 or more of assets. In these public hearings the companies examined were entitled to be represented by counsel, to cross-examine witnesses produced by the Commission, and to present evidence through witnesses of their own choosing.

The record of these public examinations consists of 33,000 pages of transcript and 4,800 exhibits. The record was not ordered printed by Congress and therefore is only available in typewritten form. I think this is regrettable.

From time to time, we have sent reports to Congress embodying the results of our study. We referred to our main report as the "over-all" report which consists of four parts.

Part I of this over-all report, which we sent to Congress on the 10th day of June 1938, was entitled "The Nature, Classification, and Origin of Investment Companies."

Part II was entitled "Statistical Analysis of Investment Trusts and Investment Companies." This part, consisting of eight chapters, analyzes the companies on a detailed statistical basis as to performance, earnings, trading in portfolio securities, investors' experience, and so forth. Before submitting our chapter on performance to the Congress, we decided we would like a check on our statistical methods by an independent expert. Dr. Edwin B. Wilson, of Harvard University, an outstanding statistician of national reputation, was selected for this purpose. He examined the report and wrote us that "it was a thoroughly sound and substantial job."

Part III was entitled "Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies." It consists of seven chapters. It discusses, as the title indicates, the evils and malpractices of all the investment trusts and companies which we studied. All these chapters, except a part of the accounting chapter and a chapter containing a further elaboration upon the abuses in the management of assets, have already been transmitted to the Congress.

Part IV, entitled "Economic Significance in Control of Industry," is an elaboration of those phases contained in the statistical portions. This part is in the process of being completed and will be transmitted to the Congress in the near future.

The Commission in addition has prepared and sent to Congress six supplemental reports dealing with (a) fixed trusts; (b) installment investment plans; (c) British investment trusts; (d) investment advisory services; (e) common and commingled trust funds operated by banks and trust companies; (f) companies issuing face-amount installment certificates. The latter is in page proof at the Government Printing Office and will be available in about 2 weeks.

In this connection I should like to state that in our recent report dealing with the accounting practices of the United Founders Companies, an expression of ours concerning accountants has unfortunately been interpreted to mean that we think the mere fact that an auditor is paid by the corporation he audits destroys his independence. This is a misinterpretation. We take no such view. We did wish, however, to call attention to the possible effect upon the auditor's complete impartiality of the fact that he is usually both selected and paid by the management. We wished to emphasize the fact that he is selected and paid by the very management whose financial acts he undertakes to audit and appraise. We wished to emphasize the primary obligation nowadays of the auditor to act for the security holders, and to lay a foundation for the provision contained in this bill requiring independent auditors to be selected by the stockholders. The value of this provision, I believe, is principally psychological. I hope that it will have the effect of keeping constantly before the auditor the realization that he acts principally for the stockholders and that in these modern days of widespread stock ownership he is not acting merely for the information of the directors or the discovery of peculations of employees.

The reports of the Commission already transmitted to the Congress cover every phase of the industry's activities. Before the Commission finally crystallized its recommendations, the staff of the investment trust study held numerous conferences with the representatives and committees on all branches of the industry, lasting over many days, and the Commission itself spent many hours in conference with these representatives, considering their various ideas and recommendations and reviewing their extensive written suggestions. This is in addition to the many hours which the full Commission has spent with the staff. The suggestions of the industry have thus been thoroughly canvassed and we have given careful consideration to all of their objections and suggestions.

I have not learned that there is a substantial opposition of the industry to the idea of Federal regulation. I do not mean by this that the representatives of the industry have approved the bill. We

made known our willingness to discuss it with them in detail after it was introduced, but with a few special exceptions they have not chosen to accept our invitation. Of course they were within their rights there. I gather from the press that there are various sections of the bill to which objection is made. Personally, I regret that after the bill was printed the industry did not see fit to confer with us.

The objectives of our participation in these hearings is to lay before the Congress, in addition to the printed reports, which busy members do not always find the time to study in detail, such information and recommendations as we have. We realize fully, that the enactment of a bill is a responsibility of the Congress, and not of the Commission. It is our responsibility, however, to lay before you as frankly and as fairly as we can the facts which we have gathered and the views at which we have arrived.

Our plan of presentation is that at the conclusion of my statement various members of the staff and individuals not connected with the Commission, whom we will suggest that you call, will try to "high-spot" and epitomize the outstanding facts which have been developed in various situations. A brief synopsis—too brief, I fear—of the statistical analysis will also be presented.

We take no special pleasure in parading before this committee the unwinsome remnants of the evil or careless deeds of some of the investment-trust sponsors and managers. We do it because it seems necessary to do it, in an effort to prove the need of regulation and to give the committee an adequate basis upon which to form a judgment on the differences of opinion between the Commission and the industry, which will be made known as these hearings progress. I personally am convinced that without legislation which at least approximates this bill the abuses and deficiencies in the industry as a whole will not be eliminated.

We shall also call to the attention of the committee various bills in equity which the Commission has brought against various investment trusts to enjoin the sale of securities of trusts by methods which are, to say the least, questionable. Some of them went to trial. More of them resulted in consent injunctions. We didn't ask them to consent; I assume they consented because they wanted to. The Commission has also had a number of stop orders against companies which have registered, or attempted to register, under the Securities Act of 1933. They will be described by members of the staff of the Commission. We shall also bring to the attention of the committee a number of criminal cases, some of which grew out of the Commission's investigations, some of which are still pending, and some of which have resulted in convictions.

I would like to state in a very general way what the objectives of the legislation are. The details of the legislation if you indulge my plan will be discussed by the various members of the staff who are more familiar with the technical details than I am.

First of all, we realize, as I have already stated, that the bill is the responsibility of Congress. I have seen enough of the legislative process to know that bills, like plays, are not written but rewritten. At the same time, I believe that this bill is a reasonable and a fair bill. My personal opinion is that some provisions are somewhat too lax. The mildness of many of its provisions has provoked approval

in some quarters and criticism in others. We want to be fair and reasonable to the industry; we also want to be fair to investors.

In general, various commentators, without approving of all the details of the bill, have said that it gives the general impression of a mild and well-considered measure. Among these may be noted the New York Times, the Christian Science Monitor, and the St. Louis Post Dispatch.

Before I point out some of the things that this bill does, I should like to point out some of the things it does not do.

In the first place, the bill does not attempt to set up an ideal form of investment company and then compel all companies to conform to the ideal. Its provisions have been scrupulously adapted to the existing diversities of investment company organizations and functions.

In order that the committee may fully appreciate the varying forms which investment trusts and companies take, let me briefly describe the various types. And I think when you listen to the description of the various types you will realize why it has been difficult to draw a bill, there are such variations.

First, there are the management investment companies. The distinctive feature of these companies is that no restrictions, or only limited restrictions, are imposed with respect to the nature, type, and amounts of investment which their managements may make.

Management investment companies fall into two broad classes, the open-end and the closed-end type. The peculiarity of open-end companies is that they issue so-called redeemable securities—that is, as security which provides that the holder may tender it to the company at any time and receive a sum of money roughly proportionate to the current market value of his share of the company's assets. Because of the exercise of this redemption feature, the assets of most open-end companies would constantly be shrinking if they did not constantly sell new securities to new investors. It is because of this constant sales activity that these companies are called open-end companies. Presumably, the name was suggested by the familiar term "open-end mortgage." Closed-end companies are management investment companies which do not have this redemption feature. They do not distribute their securities continuously but only from time to time as they need new capital. Up to 1929 nearly all investment companies were of the closed-end type. However, the open-end companies, though a relatively recent development, have expanded rapidly and now have total assets whose value is approximately two-thirds of the value of closed-end assets.

Then there are the fixed or semifixed investment trusts. In this type management discretion is completely or almost completely eliminated. The investor is sold an undivided interest in a specified package or unit of securities which are deposited with a trustee. The underlying securities cannot be changed at all, or can be eliminated only upon the happening of certain specified contingencies, such as the passing of a dividend on any security in the package for a prescribed period of time, the reduction in the investment rating of the security by a prescribed statistical service, and similar reasons.

Another type of investment company is the so-called installment investment or periodic payment plan, which is in essence a device to sell investment trust or investment company shares to the public on the installment plan. These plans were designed to tap the savings

of individuals in the lowest economic and income strata of the population for investment in common stocks. Some plans provide for installments as low as $5 a month but the usual payment is $10 a a month, and the period of payment is generally 10 years.

The final variant of investment enterprise studied by the Commission is the so-called face-amount certificate company. Although these companies have been in existence in this country since 1894, the greater portion of their certificates have been sold since 1929. In essence the certificates sold by those companies are contracts between the corporation which issue them and the purchaser, whereby in consideration of the payment of certain specified installments the corporation agrees to pay to the purchaser at maturity a definite sum, the "face amount" of the certificate; or to pay prior to maturity a specified surrender value of the certificate. As in the case of installment investment plan, the selling commissions or "load" on the face amount certificate are taken out of the installments paid within the first and second years. As a consequence, the surrender value of the certificate during the early years is small and the investor who defaults or permits his certificate to lapse sustains a substantial loss. Though there are relatively few companies in this field, they are quite large. The two largest companies and their subsidiaries have aggregate assets in the neighborhood of $190,000,000 and have outstanding certificates with a face amount of over $1,000,000,000—the amount which these companies will have to pay if all investors make the required payments in the meantime.

The bill does not attempt to tell investment trusts that they can or cannot engage in this or that activity. There is not the slightest conscious effort to circumscribe or restrict the initiative or the enterprise of managers. The bill does not attempt to say to the investment trust, "You cannot make this or that kind of investment." It does attempt to say, "If you regularly make this or that kind of an investment you must make disclosure and obtain your stockholders' consent to this fundamental business; you must wear the label appropriate to your business; and you must conform to the type of regulation that is most appropriate for your kind of a company."

For example, the bill does not prohibit investment companies from actively trading in securities or engaging in underwritings. However, we feel very definitely that a company which risks a substantial part of its capital in underwriting, or a company whose principal business is to speculate actively, should be clearly labeled as such a company and should have the consent of its security holders to engage in these activities.

The bill does not attempt to compel investment companies to change their existing outstanding capital structures, or to simplify their existing pyramided investment company systems. It does provide, however, that in the future these companies shall issue only common stock, except in connection with consolidation, mergers, and reorganizations.

Nor does the bill require the segregation of investment bankers, brokers, and distributors from the management of investment companies, a step which various officials of investment companies themselves advocated in the hearings before the Commission. However, to prevent the evils which may result from the divided loyalties,

certain specific restrictions are imposed on affiliations involving conflicts of interest.

The bill does not prohibit management contracts although there was expressed by many officials the opinion that they should be abolished. It does require that management contracts meet certain specified conditions. Now I move to a slightly different topic connected with the bill.

Undoubtedly, before the hearings are over, there will be considerable discussion, and properly so, as to the amount of discretion which should be given to the Commission. My immediate observation is about as follows:

First of all, it seems to me that the greatest virtue of the administrative process is flexibility. I think it would be unfortunate to throw it away. A good deal of the criticism of it is based upon the false idea that the rule-making power is the power to make laws. We do not have the power to make laws. No one has the power to make laws except Congress. The Schechter decision by the Supreme Court reminded us of that fundamental principle. Congress may lawfully, however, authorize us to make rules to implement already existing laws according to prescribed standards. Despite the views that I have expressed, if Congress believes that it can write flat prohibitions into this statute which will stamp out abuses and which will not do injustice to the honest persons in the industry, that's all right with us. The fewer discretionary decisions we have to make, the easier our administrative job is. I shall not be surprised, however, if as the hearing develops you find situations where rigid prohibitions cannot be drawn and where the industry and the Senators will find that it is necessary to put a little rubber into the bill for the exceptional, unforeseeable and unpredictable cases. For example, I doubt the wisdom of undertaking to write into the bill itself uniform accounting standards for all investment trusts. It isn't a job that I would relish very much. There is, it seems to me, but one senible way to approach problems of that nature. Give the power to the Commission and then let the Commission work it out in conference as a joint enterprise with the industry and the representative accounting firms and societies of the country. I assume, of course, that the Commission should be given the power to promulgate rules relating to its own practice and procedure.

It seems to me that in the face of problems of that kind and of practical necessities that it is unwise to take all flexibility out of the act. I doubt whether the committee can solve these difficult problems by the rigid rules of statute. I doubt whether the industry believes it can be done. By way of illustration, I would like to say from actual experience that if the Securities Exchange Act of 1934 had not given us very flexible powers of exemption, the utmost confusion would have existed in the early days of registering stock exchanges and the thousands of listed securities traded on those exchanges. We had to resort to this exemptive power for a temporary period in order not to interrupt trading and in order finally to reach the statutory objective of registration, and I think it is highly significant, and I would like to emphasize at this time, that much of the flexibility of the Exchange Act of 1934 is due to the insistence of the exchanges themselves, expressed before the committees of Congress, as the reports of the congressional committees clearly show at the pages which are specified

in my printed copy of this statement. (H. Rep. No. 1383; 73d Cong., 2d sess, pp. 6–7).

Further, with respect to the substantive provisions of this bill, I do not propose to discuss these in detail, but I do wish to make two or three general observations about them.

In general, everyone seems to be pretty much agreed that the functions of the investment trusts should be to afford the small investor an opportunity to spread his investment risks by a diversification of security holdings, to furnish competent and continuing investment supervision, and to assist in making capital available for industry. In a great many instances these objectives have not been realized. The failure may be attributed to certain fundamental causes.

First, there has been no regulation with respect to the individuals who may organize and operate these companies. The bill provides for the registration of officers, directors, managers, and underwriters of investment trusts and companies. That does not mean that no one can occupy one of these positions unless his qualifications are approved by the S. E. C. The Commission would only have the authority to deny registration or revoke registration for certain specific causes, viz: (1) That the man had been convicted of a crime within 10 years; (2) that he is under injunction by a court of competent jurisdiction because of some wrongdoing in connection with security transactions; (3) that in his registration he makes a material misrepresentation to the Commission. The purpose of this provision is to prevent persons with unsavory records from occupying these positions where they have so much power and where faithfulness to the fiduciary obligation is so important.

Second, it is perhaps not too much to say that the disregard of fiduciary standards lies at the root of many investment-company problems. The fiduciary obligation of the management to stockholders is too often violated or disregarded. The bill undertakes to impose specific conditions which will insure the observance of this fundamental obligation.

Third, many investment companies have adopted complicated and precarious forms of capital structure. Under this bill they will be required to follow more conservative standards. In view of the nature and functions of these companies, I believe that there is no excuse for pyramiding or for more than one class of securities in their capital structures.

Fourth, adequate accounting regulation is in my opinion fundamental, if these companies are ever to serve the purposes for which they should be designed.

Fifth, some public supervision over mergers, consolidations, and other reorganizations is necessary for the protection of investors. The investor is singularly helpless under such circumstances. Every time, for example, there is a merger of the sort recently proposed between Atlas and Curtiss-Wright, we have a flock of letters from security holders who cannot analyze the exchange offers and do not know what to do. I think it is extremely helpful if some impartial body which has no money stake whatever in the outcome, but is in a completely impartial position, can write an objective, scientific analysis of those offers and put them in the hands of the stockholders, who will thereby, I hope, get some basis for making an intelligent decision.

This bill will, I believe, promote the dignity of investment trusts. The management of these institutions is worthy of being a separate profession and a separate charge in itself, instead of being a mere adjunct to some other line of business. What we ought to develop is a group of expert investment trust managers who do not make their profits from originating and distributing types of securities, styled principally for their sales appeal, but from wise and careful management of the funds entrusted to them.

I believe that a true mutual investment company subject to governmental supervision may be entitled to special tax consideration. At the present time, only open-end companies are the beneficiaries of this consideration. I feel that the basis of granting this favorable tax treatment should not depend upon the right of a security holder to compel the company to redeem his security but rather upon the more fundamental aspects of mutuality and regulation.

Finally, intelligent regulation is in the interest of the investment trusts and companies themselves, as well as the people who put their money into these organizations. I believe this bill will tend to restore public confidence in these institutions. These organizations could then perform the vital functions of furnishing honest and unbiased investment management to the large group of small investors who require this service. These organizations might then become a vital factor in furnishing capital for industry and the stimulation of national recovery.

Senator WAGNER. Thank you very much, Judge. Are there any questions?

Senator TOWNSEND. The Judge will be available in case we care to ask questions after we have had a chance to study this?

Mr. HEALY. I hope to be able to answer all the questions.

Senator WAGNER (chairman of the subcommittee). Mr. David Schenker, chief counsel for the S. E. C. Investment Trust Study.

STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, SECURITIES AND EXCHANGE COMMISSION INVESTMENT TRUST STUDY

Mr. SCHENKER. Senators, the Judge's talk was entirely devoted to title 1, which deals with investment trust, and investment companies.

Senator WAGNER. Will you keep your voice up please?

Mr. SCHENKER. Yes. The proposed bill also contains a short title relating to investment advisers, which encompasses that broad category ranging from people who are engaged in the profession of furnishing disinterested, impartial advice to a certain economic stratum of our population to the other extreme, individuals engaged in running tipster organizations, or sending through the mails stock market letters.

Now, you may ask, "Where does the S. E. C. fit into this investment counsel picture? How did you come to make the study?"

Section 30 specifically directed us to make a study of the influence exerted by people affiliated with investment trusts and investment companies upon their investment policies. It became quite obvious to us that there were a great many of them and we felt duty bound to make that study.

Of course, our jurisdiction was limited to that peculiar phase. However, we did succeed in getting certain fundamental data, mostly

of a statistical nature, which gave us some inkling of the scope of the problem.

Now, we canvassed every source of information we could and we learned of the existence of 394 investment counselors. That, in my opinion, does not even approximate the number of people who are engaged in this profession, or business, or type of activity. After all, the only way we could get the list was through the telephone directories. But there are many who do not even have telephones or have their offices in their hats. We could not obtain any information about them.

Therefore, our fundamental approach to this problem is in the first instance, before we could intelligently make an appraisal of the economic function or of the abuses which might exist in that type of organization, to see if we could not get something which approximated a compulsory census. Fundamentally that is the basic approach of title 2. We first would like to find out how many people are engaged in this business, what their connections are, what is the extent of their authority, what is their background, who they are, and how they handle the people's funds?

Aside from that fundamental approach, the only other provisions in that title are just a few broad general provisions which say that you cannot embezzle your client's funds or you cannot be guilty of fraud. One other provision relates to the transfer of the contracts which a client makes with investment counsel. I will elaborate on those provisions at a subsequent date.

Senator TAFT. What is the constitutional basis for regulating a person who simply has an office in Cincinnati, for instance, and advises people to come to see him?

Mr. SCHENKER. Well, Senator, we intend to submit to the committee quite a comprehensive brief on the constitutionality not only of title 1 but title 2. I do not make a pretense of being an expert constitutional lawyer——

Senator TAFT. Title 1 has to do with an investment trust which buys and sells securities. That business is more or less interstate. However, I do not see how a firm that sets itself up as an adviser, like the Scudder, Stevens & Clark people, to whom people come and ask for advice, can be said to be engaged in interstate commerce.

Mr. SCHENKER. Judge Healy wants to elaborate on that, but I would like to try to answer that. It is not unlike our approach to the investment company title. If you believe in the constitutionality of the 1934 act, then the investment company is engaged in interstate commerce because of its constant use of the exchanges which are an instrumentality of interstate commerce. Similarly an investment counsel gives advice with respect to the execution of orders relating to securities listed on exchanges and in a great many instances has discretionary power to execute those orders. In addition, they have branch offices throughout the country. In addition to that, a great many of them—not all of them—conduct their business through the mail.

Senator TAFT. I wondered if it was just on the fact that the mail is used and nothing else. That, it seems to me, is a very thin basis for its constitutionality.

Mr. SCHENKER. Senator, our provisions——

Senator TAFT. I do not quite see how, if that kind of man is subject to the regulations of the Federal Government, every lawyer in his

legal business is not subject to the regulations of the Federal Government, and every doctor. He is certainly giving advice about things that relate to interstate commerce in many cases.

Mr. SCHENKER. Well, we have attempted to formulate an exemption which is consonant with your ideas. We have said that if the investment adviser maintains his business in one State and his clients reside in one State he is exempted. It seems to me necessarily that if his major function or his primary function is to give advice relating to the purchase and sales of securities listed on the stock exchange, which is an instrumentality of interstate commerce, then that fact, in conjunction with the power of Congress to regulate the mails, is sufficient to confer jurisdiction to compel these people at least in the first instance to tell that they are engaged in that business. That substantially is the whole extent of title 2.

Senator TAFT. Of course, many law firms are engaged in that business. Our office has a fairly large estate business and we are constantly called upon to advise and counsel as to investments. It is not something you might like to do, but you have to do it sometimes.

Mr. SCHENKER. Being a lawyer myself, Senator, I took particular pains to see that we were not included within the scope of this legislation.

Senator TOWNSEND. That point may bother a layman a little.

Mr. SCHENKER. I was not merely being facetious. You say, "Well, why didn't you include lawyers?" We felt,in the first place, since a lawyer is subject to the Bar Association and there is a high fiduciary duty on him——

Senator HUGHES. He is an officer of the court also.

Mr. SCHENKER. He is an officer of the court also.

Senator TAFT. There was not any scruple about leaving him out because he was not engaged in interstate commerce?

Mr. SCHENKER. Oh, we had difficulty with that problem too.

Senator WAGNER. I do not want to anticipate your testimony, but have you some instances of the activities of these counselors or abuses in connection with their activities?

Mr. SCHENKER. In a brief time, Senator, I think I can give you a short description or over-all picture of the industry. I have brought along with me copies of the report that we have submitted to Congress, and as I elaborate I will refer to the pages which deal with these subjects. You will be able to see what those problems are.

Senator WAGNER. Would you rather go on and have us ask questions later on? What is your preference about that?

Mr. SCHENKER. For 4 years I have been asking everybody else questions, and I think it only fair that somebody ask me questions now.

Senator WAGNER. That is fair.

Mr. SCHENKER. I say we learned of the existence of 394 investment advisers. Now, the estimates as to the number of investment counsel, of course, vary a great deal. Some estimates put the number at 10,000, some at 6,000, and so forth. Now, this is fairly important: We did not obtain detailed information with respect to all these 394 investment advisers that we found, for we were conscious of the limitation of our jurisdiction with respect to the scope of the investigation we could make. We felt we could only ask people who acted as investment managers to investment companies for detailed information. We tried to get some idea of the amount of funds that these people manage

or with respect to which they have some influence. We found that 51 out of 394 companies give investment advice and have influence with respect to $4,000,000,000 of funds.

Now, it is true that substantial parts of these funds are funds of banks and insurance companies. However, if you will take a look at pages 8 and 9 of the report, you will see that with respect to 49 of these firms, as far as the total amount of funds of individual clients is concerned—and that falls in the category of "other clients" in table 6—they handle almost a billion dollars of these funds. If you will look at the other two large companies, they have individual accounts of clients of $350,000,000. So that these 51 companies alone give investment advice and handle accounts of $1,350,000,000.

These investment advisers are virtually in every State. You can get the geographical distribution of these companies on page 6. These are the firms about which we knew.

In addition, we tried to get some comprehensive analysis as to whether these people devoted their time exclusively to giving investment advice or whether they were engaged in some other occupation. If you will look at page 11 you will see the variety of other businesses in which investment counsel engage.

These other businesses are brokers or dealers in securities, publication of investment manuals and periodicals, financial counsel, general business counsel, trust work, underwriting, business management, real-estate management, real-estate dealers, evaluation of securities, training analysts, holding company, insurance broker, estate planning, estate and tax counsel, import and export merchandise, industrial management and reorganization, investment bankers, mining, and so forth.

It is true that there are some people who feel that the investment counsel is in a profession just like the legal profession and that all the efforts and time and activities of this company should be devoted exclusively to the giving of investment advice. I will discuss an investment counsel association which has been formed and some of the things they hope to accomplish along that line.

Now, I cannot impress too strongly upon the Senators the fact that our title 2 does not attempt to say who can be an investment counselor, who can't be an investment counselor, and does not even remotely presume to undertake to pass upon their qualifications. All we say is that in order to get some idea of who is in this business and what is his background, you cannot use the mails to perform your investment counsel business unless you are registered with us.

What is this registration requirement? What does it amount to? It discloses their name and address, who are their partners, what is their background, what is their experience, what is their discretion over their customers' accounts, and we ask them if they engage in any other business. If they have been convicted in connection with a securities fraud or if they are subject to an injunction in connection with a securities fraud, we have the right—we are not under duty—after considering all the factors, if we think that the public interest would be injured, to say that "We will not register you."

Now, I have discussed this title at great length with the representatives of the industry. Of course, it is always difficult to presume to talk for somebody else. I think by and large that the people in the investment counsel business may perform a very valuable function.

But, Senators, what is the situation? The very wealthy man has his own private investment counselor. The individuals in the lower income stratum cannot afford any investment counselors, because the advisers usually charge a minimum fee. You have that tremendous population in between these two strata, people of moderate wealth, who feel that they are not competent to pass upon their investments. It is that portion of our population that these advisers can serve. And some want to do that job.

However, they are impeded in doing that job by the fact that there is a fringe of people who do not perform that function, but who, if I may use the expression, crash in on the good will of these reputable organizations which have the substantial research organizations, by giving themselves a designation of investment counselors. These individuals are nothing more than tipsters, who have outrageous arrangements with respect to profit sharing, and so on.

I think—and I say again I do not presume to talk for the investment advisory services—that the investment counsel industry would desire the simple approach of Title 2 in the first instance. I am not saying they may not have difficulty with some of the language or the way we phrased the provisions. I think you will find that is true with respect to the portion of the bill which relates to investment trusts, investment companies, but I anticipate—at least, I believe—that they will go along with the title as it is drawn.

Senator TOWNSEND. You speak of your limitations under this authority. In what way are you limited?

Mr. SCHENKER. Now, Senator, Title 2 begins——

Senator TOWNSEND. I mean in your study. The language here is very broad:

> The commission is authorized and directed to make a study of the functions and activities of investment trusts and investment companies, the corporate structures, and investment policies of such trusts and companies, the influence exerted by such trusts and companies upon companies in which they are interested, and the influence exerted by interests affiliated with the management of such trusts and companies upon their investment policies, and to report the results of its study and its recommendations to the Congress on or before January 4, 1937.

Mr. SCHENKER. You notice that language says we are authorized to make a study of investment trusts and investment companies, which is different from investment counselors, because investment trusts and investment companies sell their securities to the public, and an investment counselor is a partner or individual who has a professional relationship with a client. He is not part of the investment trust or investment company except as he may give advice to an investment company or investment trust.

We made a detailed study of the investment companies. We expect in a few days to tell you what we found. But with respect to the investment counselors, we felt that our only jurisdiction was to get some information with respect to those investment counselors who are associated with investment companies.

The jurisdiction to investigate investment companies was broad. The only thing we could do with respect to investment counselors was to find out what influence they exerted on investment companies and we have done that.

Senator TOWNSEND. Well, what, if anything, has held up the report that should have been made in 1937 until 1939?

Mr. Schenker. I am glad to answer that question, Senator. The Public Utility Holding Company Act was passed, if my memory serves me right, in July of 1935. The 1933 act had been passed, the 1934 act had been passed, and the 1935 act had been passed, and in connection with every one of these acts, Senator, there were certain organization problems.

We tried to get started as fast as we could, and my recollection is that we started holding conferences with the industry in connection with the preparation of a questionnaire to be sent to the industry sometime in November or December of 1935.

Now, when we come to analyze this industry, Senator, I thought, as probably you do, an investment trust is a simple organization run by people who are expert managers. You turn your money over to these organizations and they manage it. Apparently, therefore, it looks like quite a simple matter. However, when we came to study the industry we found that the situation was not that at all.

In the first place, you have investment companies which give their management untrammeled discretion with respect to the investments they can make. Then you have the so-called fixed trusts, which were devices whereby management was completely eliminated. You had the so-called open-end companies, and that is the Boston type of company, which gives the stockholder the right to redeem his share at asset value. Then you have the type which sells a face-amount contract, which is nothing more than a contract, a promissory note to pay a specified sum, which you purchase on the installment plan at $10 a month. Not only did you have these broad classes, but in each type you had a variety of types. In connection with the management companies, some companies say, "We are management companies but we limit our discretion with respect to special types of securities like insurance stocks."

That is not so bad; complications are all right, but the fact is that during the very course of our investigation the basic underlying nature of the industry was changing. Up to the time we started our investigation most of these companies were closed-end companies which had raised their funds in 1929. Their securities were selling at a discount, and in order to overcome that situation new types of companies were being organized and emphasis was being placed on new type of investment companies.

While this investigation was going on there suddenly appeared a type of situation like this: Investment-trust certificates were being sold to the public on the installment plan, and that means that they were getting down to the lowest stratum of our economic population. As we will show, that development took place during the very course of the investigation. So we had a situation where servant girls, miners, policemen, letter carriers—we will have a full list of these occupations—were being sold equity stocks under the guise that they were investing in a savings plan. That problem was almost equal in scope to the one which existed before. These Boston companies which had previously been in existence grew tremendously in that period and they presented peculiar problems. Their problems mostly related to the distribution aspect, because in an open-end company the stockholder can say, "Here is my certificate. Give me the asset value of my certificate."

The assets of open-end companies rose to $600,000,000 in this period.

Senator, you were not here when Judge Healy made this statement—and that is one of the things that in my opinion makes it essential that this legislation be passed—that at the very time we were conducting this investigation some of the most outrageous abuses and wrongs were being perpetrated. I thought every day, "Thank God, I am through with hearings," and then I would get a telephone call. Somebody was looting another investment trust by some other method, and we had to start all over again.

The fact is that one of the most outrageous things, and you will hear all about it tomorrow, took place in the latter part of 1937. Here I was in the midst of writing my report. Through some fortuitous circumstance we got the information about this looting and I had to undertake an investigation of the whole Continental Securities case, where they cleaned out the First Income Trading Corporation out in Detroit, Mich. They cleaned out the Continental Securities Co. Then they got into the Bonding Share Co., the Reynolds Investing Co., the Burco Trading Corporation, and the Insuranshares of Delaware Corporation.

Senator Townsend. Do you not think, if that happened in 1937, Congress was entitled to a report earlier than this on that matter?

Mr. Schenker. Maybe I am to blame a little for that. I have listened to statisticians a little too much, and if you ever had anything to do with a statistician you will know the meticulous care with which they want to prepare the information. The fact of the matter is that we have a thousand pages of statistics, and Prof. E. B. Wilson, of Harvard University, said that it is one of the most thorough jobs he has ever seen.

The fact is that we made progress reports to the Congress as we went along and we started sending out our reports on June 10, 1938. That is in addition to the summary reports that were sent up.

Then, Senator, no one is more mindful than I am of the technical aspects of this business. I just did not want to go haywire and I just wanted to make sure, as did the Commission, that we understood every aspect of this business, that we understood every aspect of every subdivision of this business. We wanted to do a most competent, objective job, and I think the consensus of opinion, even among the industry, is that we did that. We may have taken a little longer than we should have.

Senator Taft. How big a force has been used on the work?

Mr. Schenker. We started, of course, in the first instance, with a staff of about 45, which included people who had to go out in the field. Now, you take one of the biggest system investment companies, the Founders companies, to which $500,000,000 of the people's money was contributed by 1929 and in which the stockholders lost $376,000,000. There was nobody there to help us make a study of these companies. They literally did this, Senator——

Senator Taft. I am not criticizing you. I was just trying to find out how many worked on it.

Senator Wagner. You started to say "They literally did this." You did not finish.

Mr. Schenker. They took two roomfuls of books and dropped them in Bill Spratt's lap.

In direct answer to that question, my guess is we had 45 to 55 people in the first instance. As we completed the field investigation we kept letting the men go and depleting our staff.

Senator TOWNSEND. You can furnish for the committee the number of people and the cost?

Mr. SCHENKER. Yes, sir.

Senator TAFT. Will you do that?

Mr. SCHENKER. Yes, sir. In that connection, if I may make this observation, I think you have got to study that figure with two or three things in mind. May I take a second on that.

Senator TOWNSEND. Yes. I was only trying to find out for the information of the committee.

Mr. SCHENKER. It was during the course of our investigation that the use of Bahamas Corporation for avoidance of income tax was uncovered. In the second place, because of our investigation, in my opinion—and I was never more serious—we have saved the investor many millions. Let me give you an example. You asked me why I did not get it finished before, and maybe this will explain it to you.

Our jurisdiction in connection with investment trusts was limited to the investigation and making reports to Congress. In the early part of 1938, after the Continental Securities clean-out, a person who controls an investment trust came to me and said, "I am going to sell control of this investment trust to Mr. So-and-so."

You would think, when he said, "I am going to sell control of this investment trust to Mr. So-and-so," that he owned that investment trust. What he had was some of this tricky management stock, which had been issued in the first instance to the management. The fact of the matter is his stock had absolutely no asset value and all of the assets really belonged to the senior security holders. Yet he was going to sell the trust.

I said, "To whom are you going to sell the trust?"

He said, "Mr. So-and-so."

I said, "What are you getting for your stock?"

He said, "Well, we are going to get $2,000,000," which was a $2,000,000 premium on the stock, Senator, because my recollection is that the total assets would have to come back approximately $2,200,000—before his stock was worth nothing, you see.

I said, "How is he going to pay you for that stock?" I said, "Anybody who will pay you a million dollars or two million dollars for stock that is under water 50 dollars a share must have some fancy ideas. The only way he could get his money back is either to put his hand on the cash register and take the money or he has some crackpot theories that he can run the trust in such a manner as to get his money back."

He said, "He is going to buy the control block of stock. Simultaneously I am going to turn over the board of directors to him. He then expects to liquidate the blue-chip portfolio, pay me for the control block; then in order to reimburse the investment trust he is going to"——

Senator TAFT (interposing). Is it fair to ask who the party was?

Mr. SCHENKER. Yes, it is fair. The prospective purchaser of the trust was an individual by the name of McDermott, and I do not

hesitate to mention his name at the present time because he is under indictment.

I said to him, "You just saw what happened in the *Continental case.* This is the same razzle-dazzle they are trying to work.

He said, "I have my control stock and any safeguard you suggest I will interpose."

I said, "Why don't you tell your stockholders that they are going to sell the blue chips to somebody and are going to substitute real estate mortgages? Why don't you wait until the annual meeting, so they know what is going on and they can protect themselves?"

Evidently he shied clear of the transaction. What happened? If you read the newspaper, Mr. McDermott is the one who a couple of months ago bought control of an investment company with assets of approximately $100,000, started the printing press rolling, and then printed bonds and real estate mortgages. Those were the bonds and mortgages he sold to that investment trust.

I will give you other illustrations. We will bring letters where the people said they were going to commit similar acts. It is my opinion that had not the study fortuitously been proceeding as it was, you would have had many more clean-outs.

Senator TOWNSEND. What happened to the first transaction?

Mr. SCHENKER. They didn't go through with it.

Senator WAGNER (chairman of the subcommittee). Do you care to present anything else now?

Mr. SCHENKER. No, sir. If you care to take another witness, in order to give the committee some background on this subject we may have one of the members of the staff tell the story of what happened to the biggest investment trust that existed in this country. It will give you some idea——

Mr. HEALY. Perhaps you would rather hear that tomorrow morning?

Senator WAGNER. Perhaps we can do that tomorrow morning. I understood Mr. Cook will be here.

Mr. SCHENKER. He is the trustee for the Continental Securities Co. He is going to tell you about the *Continental case.*

Senator WAGNER. That is the case to which you referred a moment ago?

Mr. SCHENKER. Yes.

Senator WAGNER. How large a sum did that involve?

Mr. SCHENKER. Continental Securities, about $5,000,000.

Senator WAGNER. Very well, then. The committee will recess until tomorrow morning at 10:30.

(Thereupon at 12:10 p. m. an adjournment was taken until tomorrow, April 3, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

WEDNESDAY, APRIL 3, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Glass, Maloney, Hughes, Herring, Miller, Downey, and Frazier.

Senator Wagner. The subcommittee will come to order. Mr. Alfred A. Cook, will you take the third chair on this left side of the table over here?

Mr. Cook. Certainly, Mr. Chairman.

Senator Wagner. I think I have the right to say that Mr. Cook is one of our distinguished citizens and one of our outstanding lawyers in New York. He is counsel to the trustee for the Continental Securities Co., and has been invited here by the subcommittee because of his experience with that company. I am sure he can enlighten us.

STATEMENT OF ALFRED A. COOK, TRUSTEE FOR THE CONTINENTAL SECURITIES CORPORATION, NEW YORK CITY

Senator Wagner (chairman of the subcommittee). Mr. Cook, you have had an opportunity to read the bill, S. 3580, now before this subcommittee, I take it?

Mr. Cook. A part of it carefully and a part of it hastily. I gave my particular thought and attention to those phases of the bill which, as I saw it, would prevent such happenings as those that characterized the existence of the Continental Securities Corporation in its last phases.

Senator Wagner. Perhaps we had better permit you to proceed with your statement to the subcommittee. We are very anxious to have it.

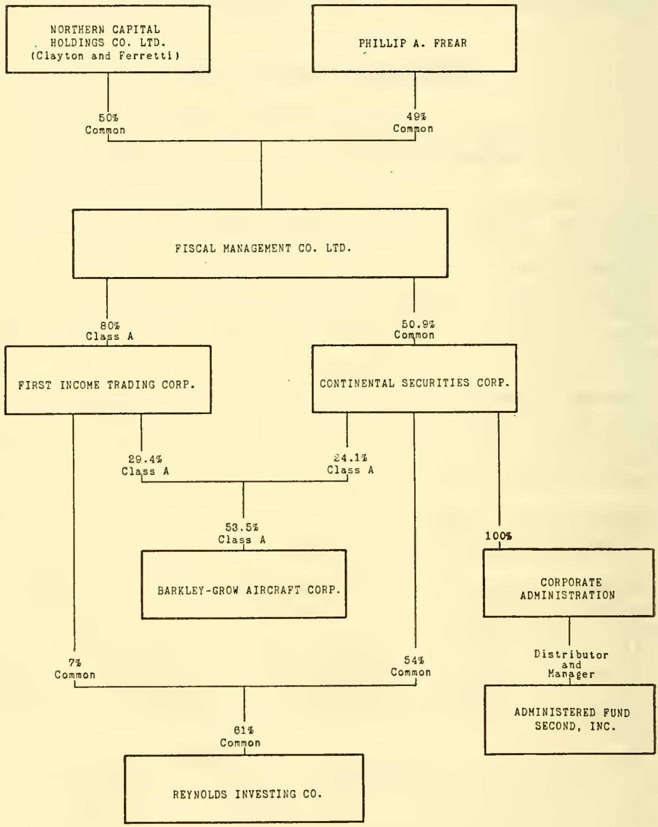
Mr. Cook. May I say this: I can appreciate that with the exception of the members of the bar on your committee, lawyers generally like to talk, and if in my exposition I am too lengthy and express views that you or your associates do not want, merely correct me.

Senator Wagner. I do not think that will be necessary.

Mr. Cook. In March of 1938 Judge Patterson of the Federal Court, Southern District of New York, appointed Mr. Arthur A. Ballantine temporary trustee of the Continental Securities Corporation—application for its adjudication in a bankruptcy proceeding being before Judge Patterson.

I had the privilege of being asked whether that firm and I would act as counsel for the temporary trustee, and I accepted. We went into the affairs of the Continental Securities Corporation I think with very great care, went through its affairs in all its aspects.

(Chart submitted by Mr. Cook is as follows:)



Mr. Cook. I think as a matter of fairness I ought to state that we were very much helped in our inquiry by what I regard as the very efficient and vigorous examination undertaken in New York by Mr. Schenker in behalf of the Securities and Exchange Commission.

The temporary trustee and his counsel had a job to do because in October of 1937, just 5 months prior to the appointment of Mr. Ballantine as trustee, we found that the portfolio of the Continental Securities Corporation was worth, at an estimated market value of the securities in the portfolio, $3,300,000. That is it approximately,

although I might be a few thousands of dollars out of the way, but nothing material.

At the time of the appointment of Mr. Ballantine as trustee there was in the portfolio about—well, at the outside, $50,000. If I may be pardoned for using a colloquial expression, Mother Hubbard's cupboard was quite bare.

The problem presenting itself to the trustee and to the firm and myself was this: How was it that in the short space of time of five months $3,300,000 of worthwhile securities were gone, except to the extent of about $50,000.

We tried to find out. That was our duty. And if I may be forgiven for going over the course of our inquiry in my own way, always subject to correction by the Chair, we found out the following: In October of 1937, at a time when the portfolio was, as I have stated $3,300,000, the banking firm that had been the managers of the Continental Securities Corporation, an investment trust which was organized in 1924, and one of the first of the investment trusts that I recall organized in this country; they approached the managers of the trust and offered them, for the majority of the shares of the Continental Securities Corporation, $20 a share.

The corporation at that time had outstanding approximately $2,800,000 of debentures, approximately $1,400,000 of cumulative preferred stock, with dividend accumulations unpaid of $33 a share; and 50,000-odd shares of common stock.

The common stock alone had the vote. The value of the common stock at that time, in October, after you allow for the debentures, the payment of the par of the preferred stock and its accumulated dividends, which was of course prior to the common stock—the common stock from the viewpoint of representation and assets was not only worthless as we saw it but was sunk to the extent of something like $22 a share. In other words, there was a minus of $22 a share for the common stock.

The offer was made of $20 a share for the stock of the kind and description of which I have spoken. Those that made the offer insisted, and it is so set forth in the agreement for the sale of the majority of the shares of the Continental Securities Corporation—and the number of shares that were to be sold was 29,000 which represented more than 50 percent of the 57,000 shares outstanding.

Senator Hughes. Do I understand that this offer was for the common stock?

Mr. Cook. Yes, sir.

Senator Hughes. Which common stock had the voting power in the corporation?

Mr. Cook. Yes, sir. In other words there were about 57,000 shares of common stock, and the offer was for 29,000 shares of that common stock, at $20 a share, aggregating $580,000. I emphasize the figure of $580,000 because it will be of some importance as I go along.

The agreement provided that the managers contemporaneously with the payment to be made by the purchasers, through the management as a condition precedent to the payment, would see to it that the then directors of Continental Securities Corporation would tender their resignations; and, following the method adopted from time to time of rotation in office, they were to see to it, before the payment was made, that those persons selected by the purchasers

to sit as directors in their place and stead, would be put into office.

Therefore there was the position for an entirely new—I was going to say deal but I will say new deck of cards, concerning which those that had been in the picture before, would be out. That transaction was carried through. The $580,000 was paid. The management contract ended at that very meeting, when the payment was made, and there were gradually elected to office, upon resignation one by one of the then directors, the nominees of the purchasers.

Now, we gave some thought to the question as to who were the nominees. We felt impressed with the idea that an investment trust, appealing to the public or investors, by reason of the confidence one might have in the management—and I do want to stop to say that the management of the Continental Securities Corporation up to that time was represented by houses of standing and houses that were held in high regard, and in my opinion, if I may be forgiven for going that far, deservedly so.

We found out that the nominees suggested by the purchasers were out of employment, either customers' men in brokerage houses, or clerks. I think one of them is now the manager of—well, I suppose he has to make a living, but of a saloon at night.

I might say that a great deal of this was also covered by Mr. Schenker in his examination, and is in the records of the S. E. C. I take it, and may be now with this subcommittee. But if I may be forgiven for expressing my own opinion, and I do not think anybody will question it, those selected were entirely unfit to occupy the positions they occupied. They were entirely irresponsible, and as I see it entirely at the beck and call of the purchasers, and whom before the court in New York and in our pleadings in the case that was brought, were referred to as "looters."

Now, it was interesting to determine how the $580,000 was paid, and where it was obtained. A check for $580,000 was given to a lawyer—and I am sorry, Mr. Chairman, to feel that a member of the legal profession was not what he should be—who represented to the banking house in Boston that as against the $580,000 there would be deposited with them ample collateral. In fact they were advised that the collateral to be deposited would have a market value of something like two and a half million dollars.

Senator Wagner. I did not get that quite clear. Did you say "a check for $580,000"?

Mr. Cook. Yes, a check for $580,000.

Senator Wagner. Why did that need collateral, if the check was good?

Mr. Cook. The $580,000 check was given by a banking house to the lawyer, and in those days, and I suppose in these, when one advances $580,000 one wants collateral.

Senator Wagner. I thought it was against the deposit.

Mr. Cook. Oh, no. This transaction was closed on the 25th of October, and this banking house as I understand it and think the record will show, learned of this for the first time 2 or 3 days before the 25th of October.

If I may be personal for a minute, Senator Glass, whom I have the great privilege of knowing, just sits there and looks at me. Well, Senator Glass, I do not blame you. And, Mr. Chairman, we found out in this matter that truth can be stranger than fiction, and what I am stating is the truth of this transaction strange as it may seem.

That $580,000 was taken by the lawyer to Jersey City, where this transaction was closed. Upon payment over of the $580,000, as mentioned before, there was a new board of directors. The old board retired. The 29,000 shares of common stock were paid for, and the destiny of the Continental Securities Corporation therefore was in the hands of the purchasers, whom I have referred to as "looters," and I stand by that statement.

What happened? The entire portfolio was in their hands now. So they sent to the banking house that loaned the $580,000, ostensibly against collateral; they sent the two and a half million dollars of collateral to the banking house, with instructions to sell securities up to $700,000. That was done. In fact, eight-hundred-and-some-odd-thousand dollars of securities were sold. The $800,000 of securities segregated from the two and one-half million dollars, were put into an account in the name of the lawyer or his associate. The difference between the two and one-half million dollars and the $800,000, was kept in a separate account, known as Continental Securities #75.

We are interested in the account with the lawyer. The banking house sold about $800,000 of those securities. It paid itself back, and properly, for the $580,000 loaned, and the usual brokerage commissions. And then, pursuant to resolutions and directions from the new contingent, paid over to the lawyer, gave him various checks, in the aggregate amount of $106,000, which $106,000 was divided by the lawyer with various others of his associates; and we find that the 29,000 shares of common stock, for $580,000, were purchased, not with outside money, but with the securities of the Continental Securities Corporation.

Senator WAGNER. In other words, they were taken right out of its portfolio?

Mr. COOK. Perhaps I have felt this situation too strongly, Mr. Chairman, but stolen. There is no question about that. So that at that time, if nothing else had happened, the portfolio had been depleted to the extent of $700,000, with nothing to show for it.

Now, of course something had to be done so far as the books of the Continental Securities Corporation were concerned, to show that this $700,000 was not stolen; that there should be some asset of some kind as against it.

Well, that was not found very difficult because those whom I have referred to as the "looters" and in our complaint filed with the Federal court were referred to as "conspirators", had organized in Canada a company known as the Fiscal Management Co., Ltd. It had really no assets. The new board of directors, however, agreed that they would buy $700,000 of the preferred stock of the Fiscal Management Co., Ltd., and then, for the 29,000 shares of common stock, paid for out of the portfolio of Continental Securities Corporation, there comes into Continental Securities Corporation $700,000 of shares of Fiscal Management Co. preferred stock, which was worthless; and the Fiscal Management Co. gets these 29,000 shares of Continental Securities Corporation, which as I have said before were likewise worthless. The books of Continental Securities Corporation show that the stealing of this, what I have referred to as collateral, in part of the portfolio, is offset by this bookkeeping figure of $700,000 of preferred stock of Fiscal Management Co., Ltd.

Now, Senator Glass, you look at me askance. I can understand why you are looking at me in amazement, but it happened. Please remember also that in connection with the $700,000 I referred to, the "conspirators" or "looters" divided amongst themselves $116,000 for commissions and what not. I suppose as I saw it, and I hope not unfairly, it was a reward for theft. I cannot figure it out in any other way.

Well, now, the Continental Securities Corporation, in the hands of the people that got it, had more things to do, because they not only depleted the portfolio to the extent of $700,000 but did other things. So someone among them conceived the idea, in their quest for the acquisition of investment trusts, that there was another corporation, known as Administered Fund, 2d, which had a portfolio of about $4,000,000. The securities were deposited with a trust company in Jersey City, I think the Commercial Trust Co. but I am trying not to mention names as I do not think there is anything to be gained by that in this inquiry, unless you direct me to do so, and I hope you will not, and of course the Commercial Trust Co. did its duty—but a lawyer and a member of the stock exchange had organized Administered Fund, 2d, and contemporaneous with its organization had also organized a company known as Capital Administration—no, I mean Corporate Administration. That is a correction, and I hope it will be the only correction. Well, Corporate Administration agreed, being the same people, for 6 percent of the value of the portfolio to pay all expenses involved in the sale of Administered Fund, 2d shares, and that they would also provide investment counsel. I think they put some money into Corporate Administration, but the venture was not a success. Corporate Administration was losing money, was worthless from my viewpoint, and I think from anybody else's.

But in the portfolio of Administered Fund, 2d, there were $4,000,000 of securities, held by 330,000 investors who invested, naturally, in small amounts.

At a time when the ownership of Corporate Administration was entirely at a loss, and at a time when all the securities were with the trust company, the representatives of those whom I referred to as "looters" or "conspirators"—and one may take one's choice as to name—went to the lawyer and a member of the exchange, and offered them $250,000 for the ownership of Corporate Administration, which from the viewpoint of dollars and cents was losing money. They must have that at that time if they are to have control of Corporate Administration, and having the management of the affairs of Administered Fund, 2d, they could then freely play with the portfolio, as they had played with the portfolio of Continental Securities Corporation up to the extent as I have stated.

Well, they obtained ownership of the shares. An agreement was drafted whereby the directors of Administered Fund, 2d, should get out and they should come in. But someone was wise enough probably to speak out, that sale of control is one thing and sale of directorships another. At any rate, when the $250,000 was paid over, the majority of the directors of Administered Fund, 2d, resigned and new men went in. A week or two later the lawyer also resigned, and now you find the "looters" and "conspirators" in control of Administered Fund, 2d.

Evidently they were impressed with the idea, for some reason or other, that this being an open-end trust, and the securities being with

the trust company, they could not play havoc with the securities because a percentage of those securities were left alone. But the $250,000 to acquire this worthless Corporate Administration was taken out of the treasury of Continental Securities Corporation, plus $104,000 which was divided amongst the "looters" or "conspirators" or their representatives. I suppose a premium to them of $104,000, for depriving the stockholders of Continental Securities Corporation of the $250,000, which was taken out of the treasury to pay for that. So to my mind the Corporate Administration——

Senator WAGNER (interposing). The $104,000 was also taken?

Mr. COOK. Yes, sir. That is $354,000. Now, you have the $700,000 that are gone with the snows of yesteryear; the $700,000 and you have $354,000 more. Well, I suppose ambition is entitled to its reward, and so the gentlemen who engineered in behalf of the "conspirators" and "looters", this Corporate Administration deal, got busy with the Reynolds Investing Co., which was one of the things you mentioned in your letter to me, Senator Wagner, when you said you wanted me to come and that you wished you might have me speak about it.

Senator WAGNER. Yes.

Mr. COOK. We have always felt, and I am glad to see that that is in the proposed bill, that with an investment trust there is the obligation that the directors, trustees, fiduciaries, or what not, owe to stockholders. While ordinarily there is nothing in the law as I see it, certainly up to the present time, which would forbid the holders of a majority of the stock of any corporation selling it, I am satisfied that under the bill that cannot be accompanied with the sale of that which they want to sell, that is, control and the election of an entirely new board of directors with respect to which no stockholder is advised, and with respect to which no stockholder can vote yes or no. So that overnight those who had been the shepherds, if I may use that term, disappeared, and somebody new and unknown to the stockholders, sat in the seats of the mighty.

Now, the Reynolds Investing Co. had outstanding approximately $3,400,000 of debentures, $991,000 of preferred stock—and right there Mr. Ross corrects me. I said the dividend arrears of Continental Securities Corporation preferred stock were $33. They were $29.

There was outstanding 1,700,000 shares of common stock, the common stock alone voting, of the Reynolds Investing Co. The controlling group that ran the Reynolds Investing Co., announced when the company was formed, their interest in it and what they were going to do, and so forth. But I do not want to go too far, nor go into too much detail, because we have some litigation pending in New York, and I would not want to try to usurp the duty of the judge who has to pass upon the right and the wrong of it; so if I do become here too much of the advocate, forgive me.

The assets of the Reynolds Investing Co. were just about sufficient to take care of the principal of the debentures outstanding, the par of the preferred stock outstanding, and the amount of dividends in arrears.

From the viewpoint of asset value so far as we have been able to determine, and I think that is in the report of the S. E. C., the common stock had little or no value. It was selling I think on the curb or at some place or other, as frequently happens. Even concerns in receivership, with little hope for the future, find some kind of market, at $1 or $2 or $3 a share, probably made or manipulated by somebody

or other. But I think I am well within the facts when I say there was little or no value to the Reynolds Investing Co., Inc., common stock shares.

These people that I have characterized come along and offer to the then directors of Reynolds Investing Co., through a banking house in New York, $2,110,000 for 1,055,000 shares at $2 a share.

Well, I suppose one can ask: Where is the $2,110,000 to come from? We all know they did not have it. But with the wrongful genius I suppose that was able to do what was done here, they made up their minds they could procure it.

So a contract was made for the purchase of those 1,055,000 shares, worth $2,110,000, and it finally is assigned to the Continental Securities Corporation. And, of course, with amenable directors—and "amenable" in any way one wants to term that word—Continental Securities Corporation was to acquire control of this other investment trust, Reynolds Investing Co.

I hope I am making clear what was done. If I am not, any questions won't disturb me, Senators.

Senator Downey. Then I would like to ask a question right there. About what time was this?

Senator Hughes. I understood it was in 1937.

Senator Downey. Was it in October?

Mr. Cook. From October of 1937 to the end of 1937; yes, sir.

Senator Wagner. In modern times.

Senator Hughes. Yes; in the second period of prosperity.

Mr. Cook. Well, I do not know, Senator, what the period was. I have given my thought and interest to the fact that things were done which in our opinion should not have been done. And that is why if I may say it—and not speaking for your entire bill, Mr. Chairman, because I do not want to talk about the entire bill, and I am not sufficiently competent to speak about the entire bill, but with reference to the provisions of the bill to prevent the happening of the things I am speaking about—I think they are wisely wrought. If they had been in the law and one was not forced to fashion a new control, such as I think, and I hope I am not immodest in saying, our trustee tried to do, all these things would not have taken place.

Senator Glass. Well, were they legally done?

Mr. Cook. Senator Glass, we say "No."

Senator Glass. What has been done with the looters?

Mr. Cook. Some of the looters were brought before the district attorney in New York, indicted, and a trial had. Those that were brought there were acquitted, but——

Senator Hughes (interposing). What were they indicted for?

Mr. Cook. They were indicted for the larceny of $700,000. But they were acquitted, Senator Glass.

Senator Herring. Mr. Chairman, I wonder if the witness could speak louder. We cannot hear a thing down here at this end of the table.

Mr. Cook. I am terribly sorry. Is there any part of what I have said that you gentlemen down there did not hear and that you want me to repeat?

Senator Herring. No. I think it would be much easier to try to tell you what we did hear. But go ahead from that point.

Senator Wagner. I think you were about at the point of telling us where that $2,110,000 came from.

Mr. Cook. At the time I was answering Senator Glass about the indictment. Senator Glass, there was a trial in the Federal court for mail fraud and conspiracy, and the jury there convicted, but only some of those I have called "looters." There is another proceeding pending in the Federal court, I suppose on a broader indictment, against some of those I have called "looters," and I assume that is receiving the attention of the United States attorney.

Senator Hughes. The court did find they had violated the law then. Senator Glass' question was whether it was lawful or not.

Mr. Cook. I had thought that the State action should result in conviction. The judge, after the jury came in, said, as occasionally judges are obliged to do—and if I am wrong I know the chairman will correct me, because we had the honor of him sitting on our Supreme Court in New York—the judge trying that case called it a miscarriage of justice, but the jury had brought in its verdict.

Senator Glass. What was done with the jury?

Senator Hughes. It was scolded, no doubt.

Mr. Cook. Senator Glass, I think the jury should have been turned over to your tender mercies and sense of justice. Now, what was I speaking about?

Senator Wagner. You were speaking of the $2,110,000 used to purchase a controlling interest in the Reynolds Investing Co., and where that came from.

Mr. Cook. If I do not speak loud enough please remind me. I have not anything of the ability of Mr. Graham McNamee.

I believe I spoke about the $2,110,000 offered for the 1,055,000 shares of Reynolds Investing Co. stock, and said something about where it was to come from and how it was to be provided. I believe I also called attention to the fact that the contract ultimately was assigned to Continental Securities Corporation, so that the Continental Securities Corporation, an investment trust, itself would acquire the majority of the shares of another investment company.

There was taken out of the treasury, or the portfolio, call it whatever you please, in order to put through this transaction, $1,106,000, I mean from the Continental Securities Corporation. The contract with the Reynolds Investing Co.—and when I say "the Reynolds" not the company but the directors or those in control of the corporation—provided that the payment of $2,110,000 should be made in three installments—I think $1,500,000 at the end of the year, on December 31, 1937, and the balance, $392,756 on January 3, and $205,330 a few days after January 3. The reason why it was put into installment payments subsequent to January 1, 1938, was because some of the holders of the stock had the tax situation in mind and for their own purpose preferred to be in cash until after the beginning of the year. That is the story as we have it and believe it to be.

The passing of the moneys was arranged through a firm in New York, since in receivership, dissolved, and concerning whose affairs the Stock Exchange had to take an active interest so as to protect the customers of the stock-exchange house. They guaranteed the contract with the Reynolds Investing Co., and the payments were made through them.

Their first check—and I mentioned $1,500,000—their first check was to another stock-exchange house in New York that guaranteed the performance on the Reynolds' matter, and was $1,499,434.06 for a certain number of shares, at $2 a share. Of that $1,499,434.06,

$1,106,000 was the Continental Securities Corporation's money. Securities of the Continental Securities Corporation had been sold by this stock exchange house, so that Continental had with it at least $1,106,000. The remainder, approximately $500,000, had to be provided, and this was provided by the house, in receivership or bankruptcy, by utilizing the securities of its customers, borrowing on those securities so as to get sufficient money to pay this difference of $500,000.

Now, that brings you to the 1st of January. The directors of Reynolds Investing Co. step out on this first payment and the new so-called fiduciaries step in; and, of course, that gives them control of the portfolio of Reynolds Investing Co., and this portfolio is sent over to the stock exchange house that I speak of, and they start to sell securities of the Reynolds Investing Co. that were in the portfolio so as to accumulate a cash balance.

Senator Herring. I caught the word "Reynolds" several times. Do you mean Arthur or George Reynolds?

Mr. Cook. Oh, no.

Senator Wagner. Mr. Cook is talking about the Reynolds Investing Co.

Senator Herring. Oh. I thought he was talking about some Reynolds of the Continental Commercial Bank of Chicago.

Mr. Cook. Oh, no. I am talking about the directors of the Reynolds Investing Co. Two of them reside in Virginia, and——

Senator Herring (interposing). Oh. I see; it is another Reynolds altogether.

Mr. Cook (continuing). And one does business in New York as a member of a stock exchange house, and the other is his partner. If there is anything I said that gave you that thought, pray pardon me.

Senator Herring. I came in a little late, and was interested in your reference to "Reynolds."

Mr. Cook. I have purposely avoided, I think with the consent of the chairman, giving names, and when I speak of "Reynolds" I mean Reynolds Investing Co. And when I speak of the directors of Reynolds I am not singling out any particular Reynolds but mean the Reynolds directors.

Now, Mr. Chairman, perhaps this is too long.

Senator Wagner. Oh, no. I think it is very valuable testimony you are giving the subcommittee.

Mr. Cook. I believe I said: Now that they have control of the portfolio what are they going to do with it? A great many of the securities were sold by this stock exchange firm and a cash balance built up; and they had to build up a cash balance because they have not only paid $1,500,000 on this purchase, which has been guaranteed by them, but they have got to raise the difference, something like $610,000.

All right. They go ahead and sell. They raise a cash balance on the books. Here are photostatic copies of the three checks I mentioned in connection with the Reynolds deal. You will recall that I said there was $700,000 so-called par value of preferred stock of Fiscal Management Co., Ltd., in the portfolio of Continental Securities Corporation, put there by the "looters."

During the course of a few months, in connection with another investment trust known as First Income Trading, which the "looters" likewise "looted," there was given up 182,500 shares of preferred stock of Fiscal Management Co., Ltd., used in connection with First

Income Trading exactly as the $700,000 was used in the Continental Securities Corporation case; and that made a total of $882,500. Now, in order to arrange for the payment of the balance due to the Reynolds directors, it became necessary to raise some money. So securities of the Reynolds Investing Co. were sold, and then the scheme was devised of having Continental Securities Corporation, with the board of directors of the "looters" sitting there, sell to the Reynolds Investing Co., with the board of directors of the "looters" sitting there, $882,500 of this Fiscal Management Co. preferred stock, which was worthless.

Senator WAGNER. That is the Canadian company?

Mr. COOK. Yes. And as $882,500 of perfectly good securities of Reynolds Investing Co. had been sold, for bookkeeping purposes it was necessary to put in some kind of entry to show where the $882,500 went. So that was put through, and then out of the cash which remained with the stock-exchange house I am speaking of, the remaining two payments were made; and of course this $882,500 had to be taken care of in some way or other, so from a bookkeeping viewpoint it might look sacrosanct.

Therefore, the house in receivership draws its check to the order of Reynolds Investing Co. for $882,500—which of course represented the proceeds of the sale of their securities. But this check to the order of Reynolds is endorsed to the order of Continental Securities Corporation to pay for the stock of Fiscal Management Co. Then Continental Securities Corporation endorsed this check to the order of this stock-exchange house, and the stock-exchange house put this into its bank account. No, I have made a mistake there; it was never deposited. It was just a sort of carrousel, with nobody getting the ring.

Now, we have lost so far $700,000, and when I say "lost," it was filched from us, the $700,000, and $354,000 in Corporate Administration and $1,106,000 in connection with this——

Senator WAGNER (interposing). That is, the Reynolds Investing Co.?

Mr. COOK. Yes. That amounts to $2,160,000.

Now then, somebody wanted to acquire the securities of a corporation known as South American Utilities Corporation, and made arrangements with some of the banks in New York to acquire all of the securities for $2,400,000. The banks and their associates evidently had loaned the money, and in order to get their position back had to acquire the company because the obligations were not met.

A contract was made for $2,400,000 with one of the associates—those that perhaps did not behave as well as they should—and the money on account paid from time to time with respect to the purchase price of $2,400,000, was $447,000; and that also because the nominees of these people signed anything they wanted—although I do not recall that their death warrant was offered to them to sign, but beyond that, anything; and there is $447,000 again because the contract was not completed, the balance could not be paid, and the contract was declared at an end by the banks, by the bank and its associates, so that the bank today has all the original securities which it wanted to dispose of; and the $447,000——

Senator WAGNER (interposing). Where did that $447,000 come from?

Mr. COOK. From the Continental Securities Corporation.

Senator WAGNER. Out of the portfolios?

Mr. Cook. I am trying to explain the $3,300,000.

That brings you to $2,400,000 that is gone. Well, they were sort of interested in a sort of aircraft company, and $150,000 went into that. I think they succeeded in buying some second-hand airplanes, which I suppose was for an investment trust.

It all seems to me to be so weird that it is difficult to speak of. The house seemed to think that one of their clerks ought to be dignified by having a seat on the stock exchange, so they bought a seat on the stock exchange for this young man and also dipped into the Continental Securities, and paid $75,000 for the seat, and I think in order to put that transaction through the looters and those associated with them felt that a brokerage fee or a commission fee, or something or other—I do not know what to call it—of $31,000 ought to be paid.

Senator Wagner. To be paid for what? For the purchase of this seat?

Mr. Cook. Yes.

Senator Wagner. In addition to the money paid for it?

Mr. Cook. Yes.

Then there were losses in connection with commissions claimed by the banking house for trading, buying, and selling back and forth, and then also some of the moneys were utilized to take care of the First Income Trading Corporation. That amounts to some $250,000, so I think, Senator. if you feel that I have approached the $3,300,000 with reasonable accuracy, I can be relieved of that phase of the situation.

The Reynolds Investing Co. was forced into bankruptcy and Mr. Ballantine as trustee has engaged in litigation, and there is 1 suit, an omnibus suit, in equity in New York against 97 defendants and everybody who was interested in this situation either correctly or improperly, on the theory, Senator, that equity, when it has all the facts, can mold an appropriate decree, so that justice shall be done to all of the parties in court.

The Reynolds Investing Co. is a party in that suit and the Reynolds Investing Co. has brought a suit against the Reynolds directors for breach of their duties and their obligations. Those cases have not yet been disposed of.

Senator Glass. Is that bank still a member of the stock exchange?

Mr. Cook. No. The stock exchange house? They are off. They are a failure. The stock exchange took them over to see that none of the customers were hurt. That had been arranged. They are off the exchange.

I think, as far as this entire transaction is concerned, if I may be permitted to say it, we have received the fullest cooperation from the stock exchange, and I think the stock exchange has done everything that it possibly could do in the matter.

I think perhaps in fairness I should say this, because I referred to the suit that we have brought: between the house that provided the $580,000 and the house that sold it shares for the $580,000 we have, with the two, already made an adjustment, with the approval of the court, upon notice to everybody interested directly or indirectly, for $1,250,000, and of the $1,250,000 about $700,000 has already been paid and the balance is in course of collection, and we have some legal details to observe, and I think that will be paid during the course of the coming week.

Senator WAGNER. I would have said that what you have told us is incredible, that it just can't happen here.

Mr. COOK. Senator, I told you when we first took this up we were impressed with the thought that truth is stranger than fiction.

Senator WAGNER. Where did the original money that went into Continental Securities come from? Do you know whether it came from small investors?

Mr. COOK. I do not know. I should say large and small investors. I think it was organized in 1924. The company got quite a lot of money from the sale of debentures and their preferred stock. As far as I am able to determine, I do not know of anything in connection with the organization of Continental Securities in 1924 that was the subject of criticism.

Senator WAGNER. The whole transaction deals with other people's money. Where did that money originally come from?

Mr. COOK. From the public.

Senator WAGNER. From the public?

Mr. COOK. Yes. If you have the small investor in mind, remember, I referred to the Administered Fund Second, where you have 330,000 investors.

Senator WAGNER. 330,000 of about $4,000,000?

Mr. COOK. Yes.

Senator WAGNER. That must represent small investors.

Mr. COOK. I brought that out to call attention to the fact that there were a lot of small investors.

I want you to know that as far as I am personally concerned the reason why the provisions of the bill which will prevent things happening such as have happened here have appealed to me is that the small investor is protected. Sometimes, I say, the large ones protect themselves; I do not know.

May I be forgiven for just saying one thing? It is not within my sphere; perhaps I ought not to say it. It is outside the provision of this bill that I have been speaking of, but I hope it will be weighed by the committee when it comes to it. I think some thought ought to be given to the fact, if Mr. Schenker will forgive me, as to whether, even under the mantle and protection of the S. E. C., investment trusts with only $100,000 should be permitted. That is in the bill.

If I may speak as to that——

Senator WAGNER. Certainly.

Mr. COOK. I am not against the small man or the man who tries gradually to develop and grow. He has got to be protected. We were all once, I think, small ourselves, but I do not see how it is possible, in connection with an investment trust, with a capitalization or assets of just $100,000 for it to have that degree of knowledge which, honestly meted out, is essential for the protection of investors, and I regard an investment trust as something which should be an investment, as it is in England.

I am fearful—I may be all wrong—that with a company of just $100,000 appeals will be made by the salesmen, those who represent them, to the speculative desires (and I suppose we all have a little flare for that in some direction or other) of many who can ill afford to lose the small amounts that they put in, except on the best of security I am fearful of that.

Senator WAGNER. Of course, in these transactions you mentioned here the small investor not only had no say about it but he had no

knowledge of what was going on at all. He had no information of any kind.

Mr. Cook. So far as what was done here, and that is the provision in the bill requiring information about changing your policy, changing your management, if you want to throw out some directors. I am entirely in accord with things concerning which the stockholders should be and must be consulted. One cannot overnight put somebody in charge of a portfolio which you have trusted, if you please, to the efforts of somebody else and not know the slightest thing about the person who disposes of the portfolio, and that is evidenced by what was done by the Continental Securities, where you have $3,300,000 of a perfectly good portfolio disposed of in 5 months so that you have $50,000 left.

I am obliged for your patience. I am sorry I did not speak a little louder.

Senator Wagner. Are there any questions of Mr. Cook? Thank you very much, Mr. Cook. You have been very helpful.

Senator Downey. I wonder if I could intervene with a comment that is not concerned with Mr. Cook's statements at all?

Senator Wagner. Yes.

Senator Downey. Is there not a better arrangement or better table we could get for this hearing?

Senator Wagner. The other day I pleaded with two members who are on the Committee on Rules. I have been after those two members about that. One of them was here a little while ago, Senator Miller, and the other is Senator Tobey. I realize that we need it very badly.

Senator Downey. Mr. Chairman, there are a hundred people here who are vitally interested in this and they cannot hear what is going on.

Senator Wagner. I realize that.

Our next speaker is Mr. Hugh Fulton.

STATEMENT OF HUGH FULTON, ASSISTANT UNITED STATES ATTORNEY, SOUTHERN DISTRICT OF NEW YORK

Senator Wagner. Mr. Fulton, you are the Assistant United States Attorney for the Southern District of New York, and you have had charge of some of the prosecutions and investigations?

Mr. Fulton. I am the attorney who has brought the prosecution of those persons who were convicted in connection with the looting of investment trusts, some of which Mr. Cook has referred to and some of which he has not.

I might give something of my background. For 8 years I defended corporate litigation in the offices of Cravath, de Gersdoff, Swaine, and Wood, and after Mr. John F. Cahill was appointed district attorney he asked me to go to his office and prosecute certain of these complicated corporate cases.

Now, among those there came up the question of the looting of these investment trusts. In the first place, I think an investment trust is a very useful thing. A person who has a small income and small savings is particularly interested in it for the reason that it enables him in effect, you might say, to bet on the United States. He could not possibly afford to buy a share of stock of each of the numerous corporations that are dealt in on, say, the New York

Stock Exchange board, but if an investment trust were pooled with the savings of thousands of these small savers into a fund of some millions, it would be able to buy blocks, which would be substantial in size, of a great number of corporations, so that the small investor would be able in effect to take an interest in all of those corporations which he could get through no other means.

Now, the particular investment trusts that are involved in Mr. Cook's litigation, and in my trial in the southern district, in the first instance issued securities to the public on circulars which made representations as to an investment policy, but, of course, that is a mere statement of future expectancy, and as the years went by the investments of those companies were changed from time to time.

In all instances they were set up in such a way that a large part of the investment was made by persons who had nothing whatever to do with the management or control of the company. For example, in the *Insuranshares Corporation of Delaware case* fifteen millions of securities were sold to the public, but the control of the company was vested in stockholders who had contributed only $50,000.

That difference between management and ownership interest is quite important because of the temptation which it affords to any person who might be dishonest to sell the corporation something that is not worth what he sells it for or to buy from the corporation something that is more valuable than he paid. Worse still, they may make an exchange, and that, of course, makes it necessary for anybody in the position of Mr. Cook and myself to establish in any litigation that we may have that the exchange was not only a bad exchange but that it was an exchange that was intentionally bad, because a mere honest mistake is a defense. In cases such as the ones that we have had we really have situations where to some extent amateurs, without sufficient financial backing, were doing it in such a raw, crude way that it was apparent, or could be made apparent. After 6 weeks' trial the jury concluded that it was intentional and convicted them.

Those convicted consisted of lawyers, some of whom Mr. Cook referred to, and two financial people, one of the financial persons being the individual who in the first instance loaned the money that was necessary to acquire the stock.

The whole thing might be said to stem back to a barroom meeting in the Hotel Book-Cadillac in Detroit. There is always the temptation on the part of a dishonest man to buy this stock which would control an investment trust. He does not care whether it has any value. He does not care what the price he pays for it might be, because he intends to foist all of it off on the corporation itself, but those who own the stock cannot, of course, sell it unless they get paid for it. They are unwilling themselves to participate in what you might term the looting of the trust, so they want to be paid—before they turn over the management—that is, before they cause their directors to resign and before they cause new directors to be elected who are nominees of the purchasers.

That means that anyone seeking to buy an investment trust would have to have cash, and in this Book-Cadillac Hotel one of the lawyers who had been convicted realized that another lawyer, who was a former associate of his, was an attorney of supposed reputable standing for one of the largest brokerage houses in the United States, and he conceived the idea that they in the first instance, through deceiving that firm, would get the firm to advance the hundreds of thousands

of dollars by a certified check temporarily, so that they could pay for the stock and get control, and in that first instance the First Income Trading Corporation—the old management—changed the board of directors and then in effect wrapped up all of the securities that were readily salable in the investment trust, took them downstairs in an elevator, and delivered them to the brokerage firm against the receipt of the check, which was then, of course, used by the sellers as the payment for their worthless stock.

That, of course, was a very easy transaction, and the conspirators went on to further fields.

Senator WAGNER. Using the same methods?

Mr. FULTON. Yes; they immediately contacted a second trust and in that case they found that the sellers would not cause the board of directors to resign until after the sellers were paid, so that there had to be what they termed an hiatus; in other words, the banking firm or brokerage firm had to loan its money without any security at all for the time being and then wait until the conspirators could get control and could loot the investment trust, by this method that Mr. Cook has described, and hand back to the brokerage firm the portfolio of the investment trust.

Now, that meant that as time went on and as transaction piled on transaction, the brokerage firm, I think—beyond a question of doubt through this one partner, at any rate, and the jury has so found by convicting him—knew that this method was being pursued.

Now, an investment trust, while it may have hundreds of thousands and even millions of dollars of assets, is little more than a safe deposit box. The securities, which, of course, represent millions, could be placed on several square feet of this table, and they are usually in the custody of a banking house.

In addition to that, the investment trust is nothing more than a set of books, ledgers, journals, and minute books, and letters back and forth to security holders.

There were one or two people who would determine what investments were to be purchased, and their whole offices in some instances were put in a space less than a third of the size of this room, and, of course, the securities are extremely liquid, and the very nature of an investment trust presupposes that there will be purchases and sales.

The only way you can approach one to see whether or not it is legal or illegal is by determining the motives which actuated the sale, and if you have got, in effect, to get into a man's mind and determine that he really knew that it was improper, it is a very difficult thing to do.

Now, Mr. Cook has described several of them and I will not describe those any further. I could not do as well as he did on those. To proceed to the next one after his, there was a corporation called Insuranshares Corporation, which was organized through the sale of $10,000,000 of securities to the public and ultimately of another $5,000,000, and, as I say, the management contributed $50,000 and it got in return the voting control which enabled them to change the board of directors and thereby to control the policies of the company.

The depression naturally resulted in losses, and at the end of about 1932 the portfolio had declined in value to about $4,000,000, making a realized and unrealized total loss of $11,000,000, if they sold out at that time. Control of that company was sold at that time for $2,000,000, and the stock had been reclassified, so that the $2,000,000

was probably a fair enough price, but the persons who got in control of this company adopted this policy of paying for the control shares in installments and they sold to the investment trust such securities as were necessary to get the money to make the investment trust in effect finance its own purchases at its own expense, and in a year's time the securities of that investment trust had declined from $4,000,000 to about $300,000 in value.

Senator WAGNER. Where did that money go?

Mr. FULTON. The money went in this way: the securities of the investment trust were sold for securities which were not worth as much as the securities which were sold. Of that sum $2,000,000 went to pay for the investment trust——

Senator WAGNER. Were there any personal profits made?

Mr. FULTON. To the stockholders?

Senator WAGNER. No.

Mr. FULTON. To the management?

Senator WAGNER. To the management, yes.

Mr. FULTON. After all, if they paid $2,000,000 for the management and then the investment trust paid that for them in effect by overpaying them in transactions in which they were interested, you could term if you wished to do so, the $2,000,000 as a profit to the management.

Now, had they been honest and kept the same securities in that portfolio, they would have gone, through the rise in the market that occurred in 1933, from $4,000,000 to about $7,000,000, so you see the result of that management was the depletion of assets by something over $6,000,000.

Senator FRAZIER. In these cases you mentioned did the original investors lose all the money they put in there?

Mr. FULTON. You can see that the people who had originally invested now had investments in a company that had only $300,000 of assets.

Senator WAGNER. Out of $15,000,000?

Mr. FULTON. Out of $15,000,000 originally. Of course, suits were instituted and they were waged over a period of years and they resulted in a net recovery in 1937 of about $300,000 after all expenses and all difficulties had been incurred.

Now, at that time that $300,000 was invested by Insuranshares in the stock of another investment trust, New England Fund, which is what we term an open-end trust. It is one of those trusts that values its securities periodically and will give any stockholder his proportionate share of his investment if he cares to turn in his securities.

In addition to that block of New England Fund, Insuranshares had about $200,000 of good, salable stock exchange securities, and in addition to that it had a third set of securities that you might term cats and dogs. They had value. Some of them had substantial value and some of them had practically no value and they were not readily salable.

The sum total of these assets by that time was, according to the management's own methods of computation, as set forth in their own contract of sale, about $815,000, and the book value, if you had liquidated the company as of that date and accepted the management's estimate of value for each share of stock, was about $2.80 to $2.90 a share.

The control of that company was held by a loosely affiliated group of individuals and bankers who held probably 30 percent of the stock, but 30 percent in many instances is working control, because proxies are sent out and not all stockholders come in, anyway.

They agreed to sell that 30 percent for a price of about from $3.60 to $3.70 a share, and in the contract by which they agreed to do that they specifically covenanted that the value of the securities would be around $2.80 a share, thereby recognizing a differential for the control value of almost a dollar a share.

Now, the company was in such shape that its investment adviser and counselor testified in the Federal Court that he had advised the directors that the only thing to do was to liquidate the company and to hand back to the stockholders whatever share of the assets were left for them. Instead of doing that, they sold this control and the provision in the contract was that they had to deliver the resignations of the directors, and they did just as Mr. Cook indicated before. The old directors, upon the payment of the purchase price for this control block of stock, and one by one as they resigned, elected the nominees of the purchasers.

Now, these purchasers were lawyers who had been convicted and are now serving time in the Lewisburg Penitentiary. They are lawyers who had no substantial assets, and their method of buying this control was this: They organized a Canadian company which they called Northern Fiscal Co., Ltd. They had previously participated for commissions in the looting of the other trusts, but this was a venture of their own, and they gave to that company some penny gold stock that they had paid about $1,800 for, but which, of course, amounted to many thousands of shares and looked well. They gave also a thousand dollars in cash for organization and legal fees in return for the entire common stock—that is, the entire stock which had the right to vote.

They thus had invested in that corporation less than $3,000, and what they did was to have that corporation sell to an agent—I would term him a stooge of theirs—$500,000 of its preferred stock, and then he in turn entered into a contract with the new directors of the Insuranshares Co. to sell Insuranshares that $500,000 par value block of preferred stock for $500,000 in cash.

Now, that meant that Insuranshares had given up five-eighths of all of its assets, and substantially all of its readily salable assets, for preferred stock of a company which had total assets of only $3,000.

That could not be permitted, so in order to give the Northern Fiscal Co. the appearance of having assets, they had the Northern Fiscal Co. receive this common stock of Insuranshares—precisely the same type of thing that Mr. Cook has described—and then have it receive the sum of about $350,000 in cash. This meant that the net result of that transaction on that day was that Insuranshares had sustained an initial loss, any way you want to figure it, of at least $115,000, and had bought its control stock for the benefit of these lawyers when I say it had sustained a loss of $115,000, that is on the assumption that whatever assets were put in the Northern Fiscal were at least available to sustain some value for its preferred stock. But that is a pretty broad assumption, because the preferred stock had no voting power except in certain events which did not and were not expected to take place, and consequently all of the assets of Insuranshares were

in the hands of persons who had indicated their good faith by stealing $115,000 at the outset.

Now, the arrangement for that seems almost fantastic. This New England Fund stock held by Insuranshares was practically cash, but it had to be taken to Boston and delivered to the officers of the New England Fund before it could be cashed. The banking firm that was advancing $310,000 to these lawyers, who did not have more than a few thousands of dollars of their own, wanted to receive that $310,000, or most of it, back the very day that it advanced it. For that reason there was a special arrangement that one of the Boston lawyers should go to the Insuranshares office, start this transaction on its way, and then immediately take an airplane from Newark to Boston and carry with him this New England Fund stock, and in Boston arrangements were made that the New England depository would keep open a little later than usual so that this block of its securities could be cashed at once. The result was that on the very day of the conspiracy the persons who had advanced the money were in substance repaid, plus a commission for their actions, and the conspirators were in charge of the company.

Now, as to directors, it can be said that at least these new directors who came in were individuals, were men, who might at least have the semblance of honesty, but everyone knows that you can get a director who has no scruples of any kind. I might mention that the cost of the five directors was $100 apiece. They did it for that. I do not believe they knew what they were doing. Their occupations were such that you would not think they were financial men.

That left this group of conspirators in control of Insuranshares. They thought it would not look right for the balance sheet to show that it had a $500,000 investment in a newly organized Canadian company that no one had ever heard of. They thought it would look much better if they could show that they had control not only of Insuranshares, but that it had bought some other trust, so they entered into negotiations to buy another trust. They were not interested in the slightest whether the assets of that investment trust were worth the price that they would have to pay for its stock, because it was not their money that was going to the purchasers.

The second investment trust was Bond and Share Trading Corporation and they concluded that they would buy the control of that company for the sum of about $153,000, and they did not even want to go to the trouble of arranging to get a temporary loan from a bank that had money enough to pay $150,000, so they had what we term a razzle-dazzle check.

They had Northern Fiscal issue a check on its bank for $131,000. Of course, the check could not have been certified and, of course, it could not have been cashed. There was no such sum of money in the account. They had Northern Fiscal also deliver whatever cash it had, and it had about $20,000. This cash with the worthless check made a total of $153,000. Northern Fiscal loaned the cash and the check to Insuranshares and Insuranshares by contract agreed to buy the stock of Bond and Share, and what they did was to deliver to the sellers of the controlling stock the twenty-odd thousand in cash and the $131,000 worthless check, which, of course, gave Insuranshares the controlling stock and control of the board of directors.

Now, the sellers were not interested in whether that check was worthless or not. They contend that they thought it was valuable, and we probably should give them the benefit of the doubt and assume that they thought it was valuable. But they had already made an arrangement that they would buy from Bond and Share Trading Corporation substantially the most valuable securities of the investment trust and would pay for them with that worthless check, and that was done.

That left Bond & Share with the worthless check, and that looked a little bit bad, so they had Bond & Share buy from Insuranshares $175,000 par value of this worthless preferred stock of Northern Fiscal which had been given to Insuranshares in place of and instead of its valuable assets.

Well, theoretically the $131,000 worthless check was too small, by some forty-odd-thousand dollars, to pay for that $175,000 block of Northern Fiscal stock, so Bond & Share not only gave Insuranshares the worthless check but it also gave Insuranshares the forty-odd-thousand dollars, which it obtained from selling such portion of its portfolio as was readily salable.

That left Insuranshares in possession of the worthless check, which it had borrowed from Northern Fiscal, and the $40,000. Insuranshares proceeded to pay Northern Fiscal the twenty-odd-thousand dollars that it had borrowed and to give back to Northern Fiscal the worthless check that Northern Fiscal had delivered.

We thus find that the worthless check originated with Northern Fiscal, went all the way around the circle, and came back into Northern Fiscal and was canceled without ever having been presented to a bank at all.

Now, in that transaction we find that Insuranshares lost money, that Bond and Share lost money, and that Northern Fiscal lost money, and there is no reason whatever why the transaction should have taken place except that which was testified to in the Federal court. That was that these various people charged commissions for each and every step in this transaction, with the result that they were paying nothing and they were obtaining individual returns by reason of the thousands of dollars in commissions that were paid out to them.

That being so, of course they looked around for other investment trusts, because it was a very lucrative thing that could not possibly fail in their estimation, and they came to the Burco Incorporated investment trust. That was a company on which stock had been sold to the public for around five millions of dollars. Through various means the value of those securities had declined to not more than a million and a half dollars. In fact, some people say not more than three-quarters of a million—But under no circumstances could you say that they were worth over a million and a half, and in the court trial there was substantially no dispute that the value could not exceed one million and a quarter.

There were preferred shares outstanding which were entitled, upon liquidation, to receive one million and a half dollars, and from that you can, of course, see that the common stock was under water. It was like the Continental stock. The assets of the investment trust would have has to increase substantially in value before the book value of the common stock was worth zero.

Under those circumstances the owners of the controlling block of that common stock entered into a contract to sell that controlling

block for $340,000, and that sale was consummated. Now, of course, that means just as it meant in every one of these other cases, that the investment trust itself would have to pay that outrageously high price, and they had a plan and method whereby just that occurred.

There was a corporation which was organized to control petroleum concessions in Venezuela. They were concessions that probably had some value. What the value is would be hard to determine, because it would depend upon how much oil could be obtained, what the cost of drilling would be, what the cost of refining and shipping would be, and it would also depend on whether they could organize a selling organization that could go out and sell the products of that company in world markets in competition with existing situations.

It was one of those things where one would have honestly to say that if millions were spent and competent management was consulted the petroleum concessions might become very, very valuable.

On the other hand, their value had been determined to some extent by an American company, which had attempted to exploit it and had given up the venture as a bad risk.

The control of these concessions was an asset in the corporation, which had authority to issue hundreds of thousands of shares of stock. Three hundred seventy-five thousand shares of stock was issued for about 60 cents a share, although that was disguised by several different contracts. I am referring to the net actual cost.

Senator WAGNER. Yes.

Mr. FULTON. And being purchased at 60 cents a share these shares of the oil company were sold at something over $2 a share to Burco, which, of course, gave the conspirators a sufficient sum of money not only to pay the $340,000 but to take for themselves over $100,000 in commissions, and it left Burco Incorporated with an asset which, so far as legal proceedings are concerned, the prosecution or the plaintiff would have to establish was not in fact worth what Burco paid for them.

In order to do that we had to obtain, and were fortunate enough to obtain, through the Department of Justice's long arm and large subpena power, the evidence in Canada and elsewhere as to that petroleum concession. The ordinary litigant might or might not have been able to obtain that. I doubt very much that they would have.

However, after obtaining that we had to convince the jury that there was no good faith in the transaction, that it was not just an honest mistake in judgment, and the jury did so conclude and those persons are now convicted.

Now, after all of these transactions had gone on there was beginning to be quite a bit of discussion of these particular trusts in the street and elsewhere, and the original conspirators became alarmed and they concluded that they would sell their interest in Northern Fiscal, which now controlled, directly or indirectly, through these associates and otherwise, Insuranshares and Bond and Share, and Burco, and they went to one of the conspirators, who in my opinion was the most brazen and who was still willing to carry on despite indications of trouble brewing, and said to him, "We will sell you our common stock in this Northern Fiscal Co. It has no asset value, but it has control value. It enables you to do what you will with these particular trusts."

He agreed to pay them a sum of between $50,000 and $60,000 for 60 percent of that common stock. He said he was not interested in the other 40 percent, which, of course, obviously had no control or asset value, providing they would let him make Northern Fiscal finance that payment.

It was done in this way: He sold to Northern Fiscal some Canadian penny gold stocks for the sum of $50,000 or $60,000 and took from Northern Fiscal cash and securities which it had in its portfolio, which in turn he delivered to those persons who were selling him the 60 percent of the common stock.

Now, that kind of thing can go on indefinitely, in the sense that as one management has taken part of the portfolio and wasted it and is beginning to believe that it should not continue in management, it can arrange for the sale of the company in its then crippled state, to some still more predatory management, which would go on and complete the thing. Ultimately you would find that there would be a tendency to have a chain of investment trusts, which in the last analysis would mean that all of them would lose.

Now, I regard these particular people as amateurish, for this reason. I thought I might be able to point out how they could have done it if they wanted to and would have made our task in convicting them much greater. Instead of organizing a company, such as Northern Fiscal, with penny gold stock and other assets of less than $3,000, if they had been men of means, they could have bought indirectly and separately sufficient shares of stock in an existing corporation to have controlled that company. They could then indirectly and separately, and in such a way that it would have been extremely difficult for us to prove it, have caused that corporation to buy the controlling stock of Insuranshares, and when we came to the vital problem of proving the intent and of disproving the defense of mistaken but honest business judgment, it would have been practically impossible to do it.

It would be easier for us to do it with the grand jury powers, because we can subpena all records, but it would, even for us, be a considerable task.

In this instance we were assisted, even with all our powers, and even with the amateurish actions of the people who were doing this, by the fact that the S. E. C., through Mr. Schenker and Mr. Smith and others, had conducted extensive examinations and had discovered a great many of the facts, and through the additional fact that the securities department of the stock exchange had likewise conducted examinations and, through their control over members of the stock exchange, had obtained documents and evidence which ordinarily, in an ordinary civil case, would not have been within the power of the plaintiff to produce.

Senator Wagner. The stock exchange authorities were cooperative, were they not?

Mr. Fulton. They not only were cooperative, but they did a splendid job in ascertaining the facts, and so did the Securities and Exchange Commission, and we started really with the benefit of what they had done and then proceeded beyond that.

Now, the ordinary litigant has broad powers, especially in the Federal court today, under the new Federal rules, but, in the last analysis, it is difficult for any plaintiff to find out what the facts are if he does not know something of what they are before he begins. In complicated cases, where you have a great number of corporations

and a great number of transactions, it is very, very difficult for a litigant to ascertain what they are before he starts, and even though he may have sufficient powers to obtain the facts if he knows what to look for, in the ordinary instance he would probably miss them in the complicated cases.

I have, like Mr. Cook, not read this bill in detail, and I have no opinion as to whether the bill is, in all of its provisions, the right kind of bill. I assume it is and I assume it is being worked on, but I do not know. However, I have read parts of the bill for the purpose of ascertaining whether this bill in its present form would have prevented the frauds, and I am firmly of the opinion that it would.

Section 13 of this bill, on page 30, specifies in subsection (b) thereof that:

> No registered investment company shall change any fundamental investment or management policy unless each such change is authorized by the vote of a majority of its outstanding voting securities.

Under that provision, if properly administrated, it would be illegal, and I assume also criminal, if a letter were mailed, to do the things that were necessary to be done here.

They could not have, for example, exchanged the New England fund stock which was a valuable investment, for the Northern Fiscal preferred stock without getting a vote of the majority of the outstanding voting securities, which not only would have taken time but would have meant publicity which would have been fatal.

Senator HUGHES. The voting securities there would be a majority of the common stock, and they had it in their own control.

Mr. FULTON. They had 30 percent. They could have called a meeting. The owners of that stock were a series of individuals.

Had they called a meeting and had they stated that they were going to transfer the assets from the New England fund into Northern Fiscal stock their participation in the transaction would have been so obvious that their liability would necessarily have made them pause before they did it.

Now, in addition, it must be understood that the Pennsylvania banks which owned the Insuranshare stock were not willing to make that transfer, and on the present record deny that they knew it was contemplated. If they had called a mettinf for that purpose they would have had to know and in this instance they would have been codefendants in the criminal case instead, as is the situation, civil defendants in civil litigation.

Now, on page 36, in section 16, there is another provision which deals with this matter, and that is the provision that not more than one-third of the board of directors can be changed without action by the stockholders.

That would have meant that they could not have transferred the control by simply causing directors to resign and, as they resigned, by electing nominees of the new interests. That would have meant that there would have had to be a stockholders' meeting, and time was of the essence in this type of transaction. There had to be a simultaneous exchange of checks and securities. It could not be 100 percent simultaneous, because you would have had to have the new board before you could authorize taking out the portfolio for the new owners, but it was so close to being simultaneous that the whole thing could be done in an hour.

If you had to call a meeting of the stockholders to approve this it would mean that whoever put up that money to pay for the controlling stock would have had to wait for days and weeks, and in addition, with that first provision about the change of investment, would have had to take a chance of the stockholders approving the change in investment policy, and in addition to that, would have had to incur the publicity.

Senator WAGNER. The publicity is very important, too, is it not?

Mr. FULTON. The publicity is the most important feature.

The third provision I had in mind is section 17, on page 36, which refers to the purchase and the sale of securities between the investment trusts and those affiliated with it.

In each instance you can see that they sold securities to the investment trust and they purchased from the investment trust. Under section 17 they could not have done that without these attendant safeguards and attendant publicity.

For those reasons, I am sure that, whatever may be the merits or demerits of the bill generally, these particular frauds could not have been consummated.

Senator WAGNER. Mr. Fulton, you have had a chance to examine the charters of some of these organizations about which you have testified?

Mr. FULTON. I have.

Senator WAGNER. Is there any limit as to what their activities can be in relation to business transactions?

Mr. FULTON. Of course, it would be impossible to say there is no limit, because it is not infinitive, but, as you know, as a lawyer, those charters contain page after page of the most broad general powers, so that the investment trust could buy, sell, and exchange almost anything for almost any purpose. The only limit that I know of is the limit that at some point either someone like Mr. Cook or someone like the prosecution authorities would step in and say that "You have definitely done this with knowledge and intent to defraud the investment trust and not simply with mistaken business judgment." That is the only limit I know of.

Senator WAGNER. Of course, we do not want to have it understood that all investment trusts are of this type. There are very excellent investment trusts.

Mr. FULTON. There are, and in addition to that, the investment trust is a very desirable instrumentality for enabling the small investor to spread his risk, and as such should be given real consideration.

Senator WAGNER (chairman of the subcommittee). Thank you very much.

I think that we will take a recess until tomorrow morning at 10:30.

(Thereupon, at 12:35 p. m. an adjournment was taken until tomorrow, Thursday, April 4, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

THURSDAY, APRIL 4, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee.
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Maloney, Hughes, Miller, Downey, Townsend, and Frazier.

Senator Wagner. The subcommittee will come to order. We will hear Mr. Carl S. Stern.

STATEMENT OF CARL S. STERN, ATTORNEY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. Stern. Mr. Chairman and gentlemen of the subcommittee—

Senator Wagner (interposing). I think you had better give your full name. As I understand it you have been one of the special attorneys who have studied the investment trust matter on behalf of the Securities and Exchange Commission, or appointed by them for that purpose.

Mr. Stern. Not quite, sir. My name is Carl S. Stern. I am one of the legal staff of the Securities and Exchange Commission. I was called into this Founders study after the preliminary work of investigation had been done, and I conducted the public hearings. I make this explanation because I do not want to come under any false representations, I wanted to keep within the limits of my connection with the investment trust study, for I merely conducted the hearings in connection with the Founders study. I had no part in the preparation of the reports, except a very tiny one—of reading them over and making suggestions. But I have recently refreshed my recollection so as to re-present this story very much abridged to the committee here.

Senator Townsend. You had no part in the preparation of the reports as I understand you?

Mr. Stern. A very small part, that of reading them over to revise them, or to suggest revision here and there. My work was entirely with other parts of the matter. As I have said, I conducted the hearings, and am fully conversant with the facts.

Senator Wagner. And what you will tell us is in connection with your conduct of the investigation?

Mr. Stern. Yes.

Senator WAGNER. And the facts themselves?

Mr. STERN. That is correct. I was assigned to this from another branch of the Commission, and my part in it was limited to what I have said. I wanted to make that clear to the members of the subcommittee for the very good reason that I do not know as much about the general investment trust study as do a great many other men here, and my knowledge is more or less confined to the Founders system, to what I discovered there.

Senator WAGNER. Tell us about that.

Mr. STERN. In order that you might have some idea of this complex situation we have had these charts prepared, which give you the appearance of the Founders group as that group existed in 1929. This story is quite a different story from that already told to the members of this subcommittee; this is not a story where there was gross or crude fraud. This is a case in which the techniques, such as were used, were refined and which was the art rather of the prospectus writer and the skill in manipulation rather than in crude handling. However, the results for the stockholders were even perhaps more detrimental than in some of the cruder cases.

Senator TOWNSEND. Your first heading states that the United Founders Corporation was formed in February of 1929, and that the capital raised was $301,741,000. Will you state how that capital was raised?

Mr. STERN. Yes, sir; but I did not want to bother with this chart at this time; rather than go into the details just at the moment I wanted to give you the general picture. I will take it up from time to time, and will start at the beginning. The story of Founders starts out with two men and $500. It starts in 1922. One man put in $500, and the other man was a bankrupt, recently discharged from bankruptcy.

Senator TOWNSEND. Who were they?

Mr. STERN. They were William R. Bull and Christopher F. Coombs. From this small beginning, in 7 years the group had become the largest group of investment companies under a single control in this country, or as far as the investment-trust study disclosed, anywhere in the world.

By 1929 the capital paid into the 13 companies shown on that chart by the public exceeded $500,000,000.

Now, so that the subcommittee may get some appreciation of what this $500,000,000 amounted to in comparison with other concerns handling investment funds, I should like to state briefly that there are 564 principal savings banks in the country, and that only one of them exceeded that figure, and that is the Bowery in New York City, and the Bowery's resources as of January 1, 1939, were $583,000,000; that out of 14,931 commercial banks and trust companies in the United States, only 16 had resources in excess of $500,000,000; that of the 306 leading life insurance companies, only 12 showed total assets exceeding $500,000,000. So that of all these savings banks, commercial banks, trust companies, and life insurance companies in the country, only 29 had assets as great or greater than Founders had at its peak.

Looking at it from another point of view, in the six Southern States of North Carolina, South Carolina, Georgia, Florida, Alabama, and Mississippi, the total savings in savings institutions, including postal savings, savings banks, and commercial banks, were $484,000,000.

In the slab of 13 States between the Mississippi River States and the coast, not including Texas, the total savings amounted to $560,000,000.

And so it was that Founders became very much of an imposing edifice, completely unregulated. It became also a national institution. There were 90,000 stockholders, scattered through 44 States. Founders at its peak controlled or held a dominant position in companies that had resources in excess of $2,000,000,000.

Within 3 years after its peak this Founders Group had declined, and the losses to the public were staggering. We will go into those losses later, with your permission. But I might say now the losses amounted to some $390,000,000 considered on an over-all basis. As a matter of fact the losses in the case of some companies were even greater; the losses in the case of some companies were in excess of 90 percent, and in the case of one company, in which $133,000,000 were paid in, the loss was complete. In 5 years that company lost its entire capital. Well, now, that is a slight exaggeration. It did have $132 at the end of that time.

Senator WAGNER. When you speak of "companies" you mean companies indicated on this chart you have handed around to the members of the subcommittee?

Mr. STERN. Yes, and which I will take up in some detail a little later on. I am trying now to give you a general impression of what happened in connection with the Founders Group, what it meant to the American public. The losses to the public were much greater than $370,000,000. The American public poured out money in a great stream, into the various branches of the system, which we will describe in more detail later on, through the purchase of stock; but the figures we now give you are the figures of money actually paid into the company itself.

The people who bought stock bought at a higher price than was charged to insiders. These were the figures representing money paid into the company by the public.

Senator TOWNSEND. Then as I understand you, the public was purchasing the stocks of these companies.

Mr. STERN. That is correct.

The rise and fall of Founders was the subject of some 6,000 pages of testimony and some 900 exhibits which were greater than the testimony itself. It was one of those gigantic jobs done by the Commission; and I can speak of it with enthusiasm because I had nothing to do with it. I merely came in to present the case at the public hearings. But it was a tremendous job, and had taken over a year of preparation prior to the public hearings.

Senator WAGNER. And I think the evidence was not always easy to secure.

Mr. STERN. Yes; and not only that, but the creative imagination of William R. Spratt, Jr., who worked long and earnestly on this matter, and I might say died as a victim of the Founders study. It was his constructive imagination that brought about a reconstruction of this situation so that we are able to present it as a lucid picture, as I think we can here; and because the picture is so large and the techniques so unusual, we will give you just the high spots. We could not hope to go into the particulars. The various ramifications are so great that we can only give you the high lights.

Starting with the men behind this Founders Group, the two original promoters were Christopher F. Coombs and William R. Bull. Coombs within a year had been discharged in bankruptcy in a case involving the failure of a Wall Street investment house of which he was a partner. Bull was and I think is today a Bridgeport security dealer, and he was then of quite limited means.

In 1925 these men were joined by two others, Frank B. Erwin and Louis H. Seagrave. Erwin was then a security salesman. He had, like Coombs, been one of the bankrupt concern's partners. Seagrave was earning a very modest salary in charge of sales of securities for a security affiliate of the First National of Boston.

I take these four men because they were the controlling inner circle and at the top of the pyramid shown on the chart. There were always these four men until 1928, when Bull dropped out of active direction of these things, and in 1928 the inner circle remained with Coombs, Erwin, and Seagrave. And Seagrave was the man who was known to the public. Mr. Seagrave became the prominent executive in the group, but Mr. Coombs was really the man with the great outstanding interests.

The $500 with which the group was started was furnished by Bull. Coombs did furnish something; he furnished what was called good will of a defunct organization—the good will and what were certainly the outstanding liabilities of a defunct investment concern. These were the assets at the birth of what was later known as American Founders Corporation, the first functioning company in the group. The $500 was all there was in the way of cash and assets then. But the $500 did not stay there very long because it was borrowed by a company in which Mr. Bull was interested. This seems to have been a tradition.

If you gentlemen of the subcommittee will look at the chart a minute I should like briefly to sketch the way the organization started. First, I have the American Founders Corporation, which is the second company in the pyramid shown on the chart. That company was founded in January of 1922. The other company that existed at that time was International Securities Corporation of America, the first of these two columns of companies at the left. These two companies were all there were to the Founders Group for quite some time. International Securities Corporation of America was said to have been formed in 1921, but that was just on paper. It had no real existence until 1922.

The group remained with these two companies, American Founders and International Securities, and this continued until 1926. In 1926 the experience of International Securities had been such that Second International Securities Corporation was created. Thereafter, in 1928, they began to start more and more companies. They created United States and British International Company, Ltd., and American and General Securities Corporation.

In 1929 the thing really began to expand in enormous drives. Then they added United States Electric Power Corporation along with General Investment Corporation and American & Continental Corporation and United Founders.

It is not necessary to comment on any of these for the moment, except a company near the bottom, which is Founders General Corporation—the second from the bottom on the left-hand side.

Founders General Corporation has a history that is very unfortunate in connection with the group because that was a wholly owned distributing concern, and the expenses of that concern were so handled, the ease with which they could raise money through it, it presents one of the most important features of the tragic fate of the Founders Group. But I will come back to that a little later on, if I may.

One of the things that I think will interest you gentlemen of the subcommittee is the way in which, as the group grew, all restrictions were thrown to the winds. They started off, in the case of International Securities Corporation of America, advertising that it was the first investment trust—and you will see that over here on the left of the chart—as I say, they started advertising in the case of International that it was going to be an extremely conservatively run corporation, that it was going to be limited in four ways: that they could invest only in seasoned securities; could not buy control of corporations—that they would be free from the burdens of control; that they would be purely investment companies.

Senator WAGNER. Did they mean by that that their charter so limited them?

Mr. STERN. Unfortunately the charter did not contain such a provision. Their bylaws did, but as you know the bylaws were subject to modification. They advertised diversification of securities. They indicated they had to have great quantities of different kinds of securities, and that that applied to industry as well as to countries. And, finally, and this is one of the most important points, they advertised they would be independent of investment-banker domination. And that was one of the most important points that they disregarded.

One by one they scrapped these restrictions. It may not be fair to say they scrapped them because what actually happened was this: They advertised in the case of International Securities, and they built up the goodwill of Founders, on the idea they were to be conservative; and they furthermore built up the idea that these restrictions existed. But as new companies came on they scrapped the principle of seasoned securities, they scrapped the principle of diversification, they scrapped the principle of not buying majority control, and finally and emphatically they scrapped the principle of banker association, as we will show, with very disastrous results.

I think the facility with which they——

Senator TOWNSEND (interposing). Did they start out by paying dividends?

Mr. STERN. Yes. I was going to touch on that very briefly because otherwise the story will get too long.

Senator TOWNSEND. All right.

Mr. STERN. The growth of the system is a matter of great interest. At the end of 1926 they had raised $38,000,000. At the end of 1927 they had raised $40,000,000 more, working it up to $77,000,000. At the end of 1928 they had raised $153,000,000, and at the end of 1929 they had raised $686,000,000, and if you deduct the criss-cross holdings they had raised $500,000,000 by that time. But the great growth was in 1928 and 1929, when they had raised these vast sums of money.

Senator WAGNER. Are you going to tell us how they raised this money?

Mr. STERN. Yes.

Senator WAGNER. And where they raised it?

Mr. STERN. Well, I was going to tell you something of the technique they used, otherwise it would prolong this story. If you gentlemen of the subcommittee are interested in any particular facts we will get them for you. I am trying to compress this Founders' story in 1 hour. If you gentlemen want any further eludication we will be glad to give it.

Senator WAGNER. Was it as the result of newspaper advertising?

Mr. STERN. Newspaper advertising and the work of salesmen. The sales technique of Founders was marvelous. They were very skillful, but generally what they did was to put themselves across with two main features.

Senator WAGNER. That was a large sum of money to raise, and I take it some very persuasive tactics must have been used.

Mr. STERN. You will see in a minute how they did it.

Senator TOWNSEND. Do you mean that this $500,000,000 was capital in the way of cash paid into them by people all over this country?

Mr. STERN. Either by them or it represented the market value of securities put in by various concerns as they came along. For instance, in the case of one of these companies, which was the United States Electric Power Corporation, and the General Investment Corporation, the original subscriptions were in cash, but there were immediate exchanges for securities.

Senator TOWNSEND. The mechanics of the situation is the matter I am interested in, and that is that the $500,000,000 was paid in to them in cash originally from stockholders all over the country?

Mr. STERN. That is correct.

Senator TOWNSEND. Now then, they of course invested that money that they had received. Did those people who paid in the $500,000,000 receive stock in the company in return for the money?

Mr. STERN. Yes.

Senator TOWNSEND. Then they invested that money in different stocks of course.

Mr. STERN. Sometimes, of course, and that was the technique I am going to discuss later. The insiders came in first and bought or committed themselves to pay or did not commit themselves to pay or were allotted stock with the opportunity to buy. Sometimes it was done that way. Ultimately the public came in.

Senator TOWNSEND. But did they receive this much money in cash from the public?

Mr. STERN. Very frequently what happened was this: When the insiders bought they were given allotments, and frequently they did not take them up until after the market had reached a certain price, and then the securities were sold to the public and they simply took their profit.

Senator TOWNSEND. I understand that method, but what I am trying to get at is this: According to your statement they received $500,000,000 in cash from people all over the country.

Mr. STERN. That is right. Some of them may have been people connected with the organization, and some of them may have been people throughout the country. But ultimately they had $500,000,000 cash capital paid in.

Senator TOWNSEND. What was the picture that they held out to the public? How were they going to make their profit?

Mr. Stern. Might I show you that a minute or two later? I would rather take that up in the regular course of presentation of this picture.

Senator Townsend. The reason I am asking you the question now is this: I have to leave the room pretty soon to attend a meeting of another committee.

Mr. Stern. Very well. I will take it up right now. The way they got their cash was to advertise two things: One was the great conservatism of management; and the other was, their huge profits. That is how they got their greatest amount of cash.

Senator Townsend. And their management was buying other stocks to put into their portfolio?

Mr. Stern. Yes, sir; the idea they sought to convey to the American public, and that idea was inaccurate, was that they were a very conservative crowd, and that they were able to show huge profits by means I intend to go into later. It is all covered in these reports, but at the moment I wanted to high-light it for the subcommittee.

Senator Townsend. I take it in the early formation of the companies they started out to pay dividends to people who had put in the $500,000,000?

Mr. Stern. That is correct, but that was of course when they were very tiny, and I am in advance of my story a little by saying this: They started out with the rather ingenious idea—whatever we may think of it: There was the holding company, American Founders Corporation, and it was the management company to manage International Securities, and International Securities at that time was the company advertised as the investment trust. International Securities was able to show a very handsome return on its capital for the simple reason it had no expenses. The expenses were all assumed by American Founders. Well, quite naturally you would ask, what about American Founders? It showed excellent returns, too, but that showing was made by reason of the simple fact that it did not charge expenses to income but capitalized or deferred them. They did that with the ordinary as well as the extraordinary expenses. They started out by showing inflated earnings, and they had other devices I will show you and show you how they actually started and how they succeeded. It was done with the livery and trappings of lawyers and accountants. It was made to appear there were all the safeguards, and it came about one by one that the safeguards did not apply, and one by one they were evaded. That is the way they conveyed the idea of huge earnings, and when we analyzed it we found that the conservatism was not there, and the earnings were not there, except by shuffling round from corporation to corporation.

Senator Townsend. Suppose we had not had a crash in the market, would the companies have continued to have made money? Was it possible for them to make money if the market had stayed up?

Mr. Stern. My personal opinion is this, that as the Founders began to be operated it required a continuing market for security distribution to enable them to do anything like what they claimed. They made money, not so much by speculation in the market, but made it by shifting securities from one company to another in the group and calling the result profits.

Senator Hughes. They did not actually sell those securities?

Mr. Stern. Yes; they sold them. But that is another story also I want to come to later on.

Senator HUGHES. I would like to hear it connectedly.

Mr. STERN. I had expected to spend a little time on that interesting phase of this story.

Senator WAGNER. I understood you to say that when any of the companies contemplated issuing additional securities some insiders got first choice; that they were allotted securities which they were probably not obligated to take.

Mr. STERN. That is correct.

Senator WAGNER. Out of options on those shares. And then the insider could watch the market, and if the value in the open market increased they could exercise their option.

Mr. STERN. That is correct.

Senator WAGNER. And thereby make a profit just by reason of being an insider.

Mr. STERN. That is correct. I was going to give you one or two instances of that.

Senator WAGNER. There is one other question I wish to ask and then you may go along with your story: Those securities went upon the stock exchange, did they not?

Mr. STERN. I think some of them were on the Boston market and perhaps the curb exchange.

Senator WAGNER. But not on the New York Stock Exchange?

Mr. STERN. I think that is correct.

Senator WAGNER. Go ahead with your story.

Mr. STERN. I would like to call attention to one other thing: Look at the top company, United Founders Corporation. That is at the very top of the pyramid. United Founders was formed in 1929. That was formed for the definite and avowed purpose of continuing the existing management. It was to continue the control of Messrs. Coombs, Erwin, and Seagrave. They exercised that control by getting one of these multiple voting stocks. They paid $1,000,000 in securities for 33⅓-percent control of this enterprise. So that they were then in a dominating and secure position, at the top of the pyramid. They put themselves in control without consulting the directors of the American Founders Corporation. They told them about it after it was complete. They did not even give stockholders of American Founders a chance to come into United Founders on anything like the terms the management did.

All I want to say about United Founders now is that they cemented themselves in control and later, after advertising that it was necessary to keep the present "conservative management" which was their term in control, they sold out control to someone else, again without consulting anybody. I do not know that the selling out of control had any bad results on stockholders because most of the losses had happened by that time.

Senator WAGNER. Was that sale profitable to them?

Mr. STERN. Yes; but not in the way the transactions we will now examine were.

I am sorry that Senator Townsend is not here to hear the reasons why Founders succeeded in the beginning as it seemed to me. They stressed, as we have said the conservative policies of the company. They pointed out that they were following the best traditions of the British trusts. Their reports disclosed those large earnings. But they did indicate, I think from the term "Founders" that was used, that they were the pioneers in America, indicating they were one of the

first companies, pioneers in the United States and following the British traditions, where one could get the advantage of buying diversity if he is a small investor, without risk. They were to have these men to protect the investor. Let us see how they did it.

In the very beginning the transactions were anything but conservative. There were these two companies until 1926, American Founders Corporation, a management company, and International Securities Corporation of America which was the managed trust. The two companies were different companies but they proceeded to commingle their assets. The assets of International Securities Corporation were held by American Founders for so-called safekeeping. The safekeeping was not entirely safe. American Founders began to sell short on the market securities of International Securities which were left with it for safekeeping to accumulate an account. They loaned to impecunious sponsors—those men of little or no means had money loaned to them, or to corporations that had no record of profits but only losses. Certain individual loans ran as high as $400,000.

When they came to the short sales they concealed them from the public by lumping together debits on short sales with the assets, so that only the net assets would be shown and no one could tell there was anything like a short sale outstanding although they were pretty large.

Then they used various methods for inflating the accounts. The methods were so reprehensible that they employed new counsel, and they said they must stop, and they did stop. In the early days, about 1926, they had stopped these earlier, cruder methods.

But the concern immediately started to use different kinds of methods, from that time on. They had used write-ups and they had done a great many things condemned under the Holding Company Act for holding companies. They had written up options. They would write up options on the assumption the price would continue on a steady level for 10 years. When accountants were asked about that they said they would not do a thing like that today but it seemed all right then. That prediction into the future happened to be disproved within 2 years. But they used a method about as bad as anything in holding companies, of writing up, and on the basis of that showing their accounts were made to appear in much better shape than they actually were.

Then they inflated their capital account by a device that was not new but certainly could not come under their classification as conservative. They issued a large quantity of stock and a large part of it was issued for notes, and they were the notes of the sponsors, who could not have paid them. So they started out by using various techniques of inflation.

The second phase started in 1926 or 1927 when they began spewing out these companies, and there again they began to concentrate on advertising their excellent research department. Now, they did have a very fine research department, which had been built up and was expensive. They had economists, and they had financial men, and they had specialists in different parts of the world. And they advertised this investment research department in their advertising matter.

But the unfortunate part about that was that the research department, as to the major activities of the group, was not consulted. The management was done by the inner circle without consultation with

the research department. And they continued to publish also the fact of their huge profits, and of course that was their big selling point.

Let us see about the investment department. It was commonly regarded as one of the best in America, they said. The head of the department said they had too heavy a job; that they had tried to police 2,000 securities and that that was too much for any investment department; that the size of it was too large to enable them to handle this thing effectively. But they did not consult it about major elements of policies.

There were large losses in the major portfolio, but as to those I will have to leave to others to tell you. That was not one of the major difficulties in the Founders' system.

In 1926 the companies began a practice which became a central fact in the Founders' history, the creation of new companies and the manipulation of their securities. And this I think is the thing that ultimately caused the downfall of the company.

They found that they could raise money and they began raising money heavily. In order to make the showing that was necessary they began this process of intercompany profits. That is, sometimes selling from one company to another, and sometimes, to answer your question, Senator Hughes, they would sell to insiders at a price which was very much lower than the price it was offered on the market, and while at the same time they had, through the agency of this Founders General, been busy keeping up the market.

Now, that profit to the insiders was a very substantial matter. Some of those men became very wealthy as we will see. And that was not the only bad feature. That feature of it, as may be best shown by an illustration I will take up, indicates that the public was not told that the great mass of profits was made in this way. As a matter of fact, and this is a fact in connection with Flounders, from 1928 to 1930 Founders registered on its books $46,000,000 of investment profits, with $43,000,000 of net investment profits. All these investment profits came from transactions in group securities. There were transactions in other securities but they resulted in a loss of $3,000,000. So that at the time of its greatest height, the time when Founders reached its zenith, $46,000,000 of profits, which were profits made from investments, were all made in handling group securities. But the public was not told that.

The public was told that a group that is constantly familiar with the markets of many nations knows where securities are cheap. It was told that the critical days of 1929 were not worrisome days for Founders, the depression was nothing to them. They were told that one has to get a detached point of view, and to understand the companies one had to know that they had the facility to take advantage of shifting from one country to another; that if the United States was no longer a good place to invest they would move to Germany or to France or to other places. But those profits were not obtained by moving from one country to another; they were obtained within the four walls of a building, by shifting those securities from one company to another.

In the main there were two techniques by which they got those intercompany profits. In the one case they sell to the companies in the group or to insiders at a price below what the securities would be immediately sold to the public.

I think I can illustrate that first technique by the formation of General Investment Corporation. That was at a time, in September of 1929, when the stock was turned over to insiders at $12.50 a share, which stock was immediately sold to the public at $30 a share. The insiders were both individuals of the group companies. The result was of course that $12.50 a share went into the capital of the company, General Investment Corporation, and $17.50 went to other people.

Now, of course a company can hardly satisfy the stockholder who pays $30 a share when it only has $12.50 a share put into the treasury. The only way these companies could have expected to continue issuing those glorious earnings statements was by continuing to spew out new companies. It was one of those chain processes that once the chain is broken collapse is bound to come, and did come.

Senator WAGNER. Were those profits to those insiders appreciable?

Mr. STERN. I am coming to that. They were very substantial.

Senator WAGNER. All right.

Mr. STERN. Judge Healy has asked me to make plain, and I am glad he did, that the securities we are speaking about now, and everything that went into those $46,000,000 of profits, were securities of the group companies, securities of companies whose names appear on this chart. Sometimes they were new issues and sometimes they were secondary issues.

Mr. HEALY. Were they portfolio securities or new issues the company was putting out.

Mr. STERN. In some cases they were portfolio securities, but we will take that up.

Mr. HEALY. But for the most part they were their own securities?

Mr. STERN. For the most part they were. But all the $46,000,000 profits were from securities of companies on this chart.

Senator WAGNER (chairman of the subcommittee). Go ahead with your statement.

Mr. STERN. Those profits, of course, ran very high. The market price of the securities was $173,000,000. The insiders of the group companies got them at $76,000,000. So that the public paid more than 100 percent more than the insiders paid.

Now, of course, that created a tremendous burden upon those companies, because if a company has $12.50 only of the $30 paid in by a stockholder, there just is not any possibility of an earning on that, except through a miracle or by continuing this chain movement.

Senator WAGNER. Did you ascertain at all what the individual profits were in those cases?

Mr. STERN. Yes. I was coming to that. But I will take that up right now if you wish.

Mr. SCHENKER. Senator Frazier, I might explain that I worked on the report and that Mr. Stern conducted the hearings. You have to get this picture: Here they started with $500. They organized one company and sell it to the public. Then they organize another company and sell it to the public, and then a third company. Now, you cannot sell securities to the public unless you paint a picture that you are making money. What were the two bases of purchase? In the first place, they must get the market price of the securities to pay, so that you had this underlying history of the company: this distributing company ran pools in the stock of the companies whose securities they were selling to the public, which pushes the price up. Then you had to paint the rosy picture that you are making money. Then they

advertise that they are very conservative, and they say: We are making millions of dollars with securities, and they say they made $43,000,000.

What was that $43,000,000? They would organize company A and then investment trust B. Then A would take the capital securities of investment trust B at 20 and sell them to the public for 40 and then after A had the 40 they would show on their books they have that much profit. That is not profit but money raised.

But they did actually do that. They have company B sell its new security issues to company A, not at 40, which they could have realized on the market, but for 20, and then company A sells to the public for 40, and company A's showing is: We made $20 a share profit, and company B makes a showing where they have $20 a share capital. So that the $43,000,000 was not $43,000,000 profit but capital raised from the public, but it was put on the books and said to be profits. That was the rigamajig of this.

Senator FRAZIER. Then it was just a bookkeeping profit?

Mr. SCHENKER. Yes. Instead of putting it on the books as capital, they sold stock to one of the companies for 20, when they got 40 on the market, and that company sells it to the public for 40, and then A company says: We made $20 a share profit, and B company says: We have $20 a share capital. It was bookkeeping acrobatics.

Senator WAGNER. Where did the individuals come in, Mr. Stern?

Mr. STERN. That is another question.

Senator HUGHES. Did the option take care of that?

Mr. STERN. There were several things there.

Senator HUGHES. I take it the public that was buying those stocks must have had more than the inducement of the representation that the companies were making money. Were they not getting dividends at the same time?

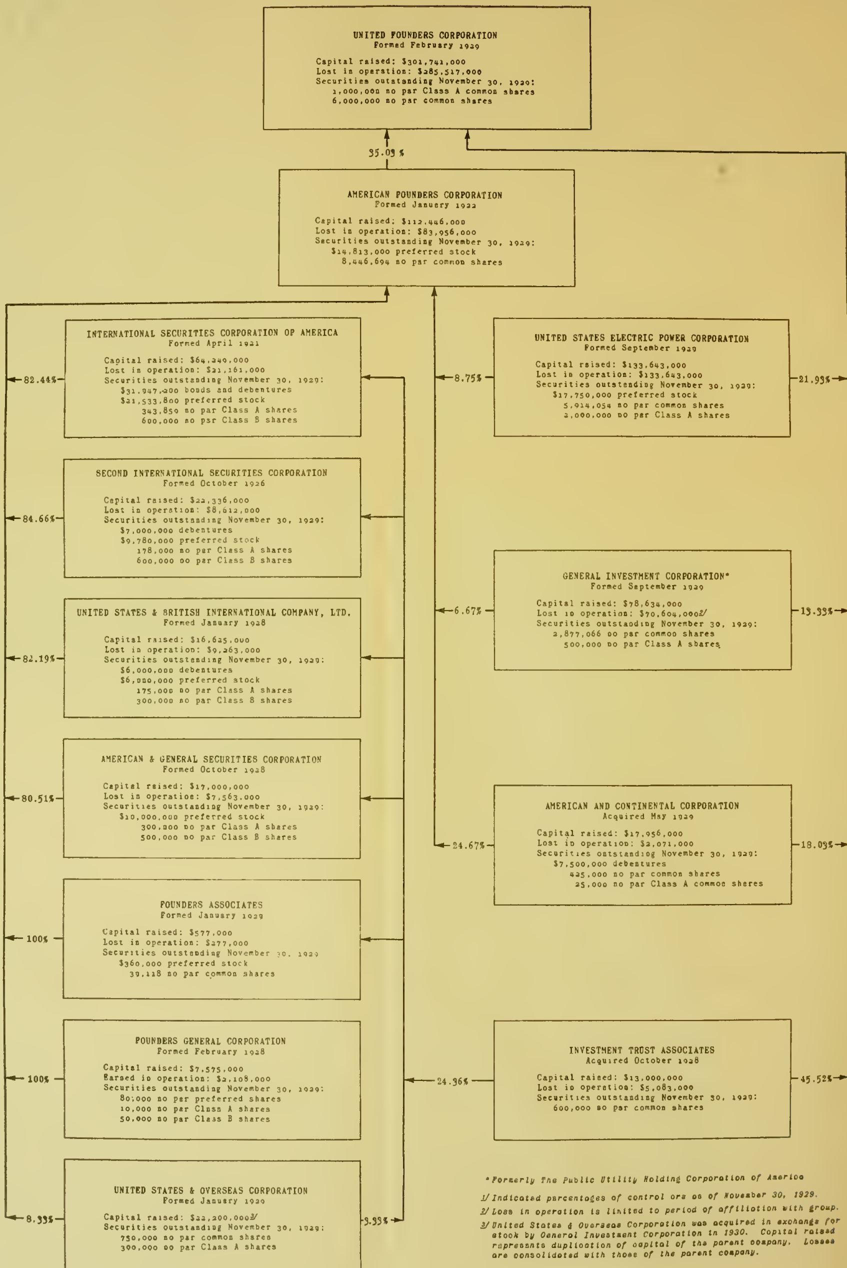
Mr. STERN. Of course they paid substantial dividends. They also showed, which was very excellent in those days, earnings per share which were naturally high, because that was entirely within their control.

One other thing: In 1929 they showed those huge advances in the prices of securities based upon those fictitious earnings. So you can see the trouble that Mr. Schenker has so excellently explained. The difficulty with a situation of that kind is that it is harmful to everybody. If company A got only 20 instead of 40, and company B got 20, then if company B could show earnings, its stocks would go up. But later there would have to be other companies brought into the picture so that they could keep up the process of trying to justify the early inflation.

Senator Wagner, you asked about the amount of profits the individuals had. The market price of those securities, as to which the first thing was used, was $173,000,000. The group companies paid $76,000,000. That meant a spread of $97,000,000, or that much possible diversion into the hands of the insiders of the group companies.

Now, as to the individual insiders, there was $54,000,000 of this $97,000,000. That is, the insiders paid $54,000,000 under the market. Now, of course they did not make profits to that extent because some overstayed their market and were left with some of the securities. As a matter of fact they did not fare vary badly. Mr. Coombs, who was bankrupt in 1922, took $4,000,000 in cash out of

PERFORMANCE AND CONTROL OF THE PRINCIPAL COMPANIES OF THE UNITED FOUNDERS CORPORATION GROUP 1/



* Formerly The Public Utility Holding Corporation of America

1/ Indicated percentages of control are as of November 30, 1929.

2/ Loss in operation is limited to period of affiliation with group.

3/ United States & Overseas Corporation was acquired in exchange for stock by General Investment Corporation in 1930. Capital raised represents duplication of capital of the parent company. Losses are consolidated with those of the parent company.

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earnings from his securities in 1928 and in 1929, after the crash, his securities were worth between $20,000,000 and $30,000,000. The others did not do quite as well as that, but quite well I would say. They all made very substantial earnings, and the potentialities were some $54,000,000.

Senator HUGHES. By way of manipulation?

Mr. STERN. Yes. There was a second method of making profits and that method was by just shifting from one company to another. I think that might best be shown by way of illustration, and while it is not the most important instance yet it is one of the most fantastic.

Mr. Chairman, I should like to also have this chart in the record;

Senator WAGNER (Chairman of the subcommittee). The chart you have heretofore been using, as well as that chart, may be made a part of the record.

(The chart entitled "Performance and Control of the Principal Companies of the United Founders Corporation Group" and the chart headed "Intercompany Transactions in International Securities Corporation of America, Class B, Common Stock" and the chart headed "Intercompany Transactions in United States Electric Power Corporation.)

Senator WAGNER (chairman of the subcommittee). You may proceed now with your statement.

Mr. STERN. If you will look at this chart you will find American Founders Corporation had purchased securities of International Securities Corporation of America. It had those securities at $8.62. It sold some to Second International Securities Corporation, which then sold later to United Founders Corporation. It sold some to United States and British International Co., Ltd., which then sold later to United Founders Corporation. Second International sold some to Investment Trust Associates, which sold to United Founders Corporation. So that by this whirligig method they all were sold, in this way.

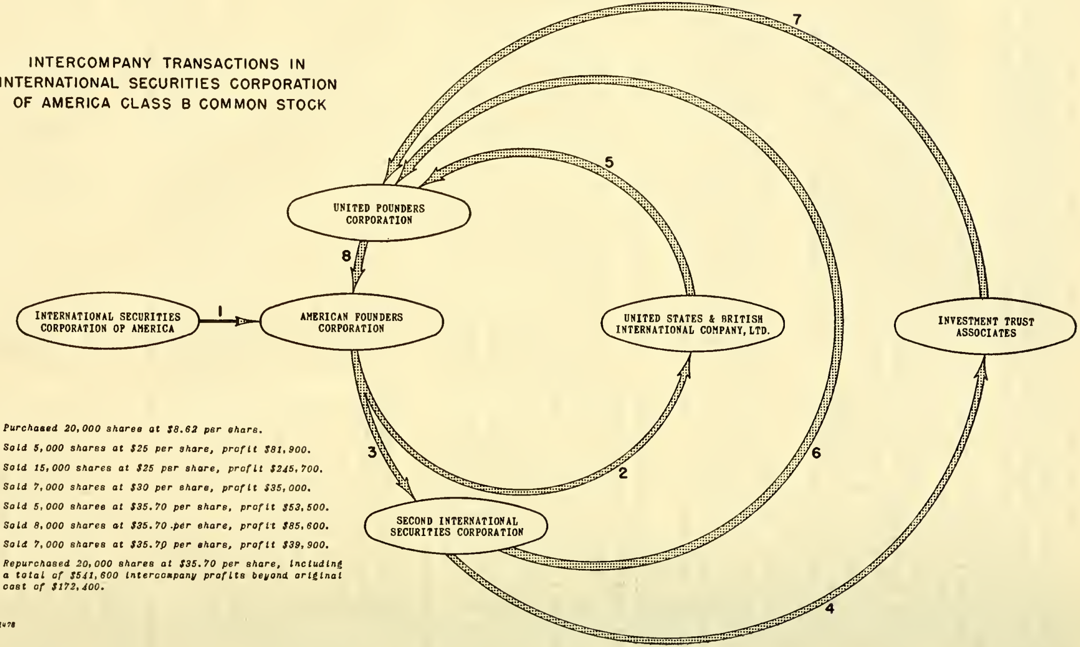
Originally those stocks were on the books at $8.62 a share. At the end of this transaction, which took several months, they were back in American Founders at 35. Of course they were not profits at all. The sum of $600,000 went to inflate the income account of these different companies by this process. Sometimes they were a little bit more complex in their technique, as is shown by this second smaller chart which I believe has been made a part of the record.

Senator WAGNER (chairman of the subcommittee). Yes; that was ordered made a part of the record along with the other two charts.

Mr. STERN. In this second chart the technique was a little bit more devious. There the United States Electric Power Corporation—and, Senators, if I go too fast stop me, because this was a rather complex transaction, both in the way it was handled and in the way it was recorded.

The American Founders Corporation held certain stocks of United States Electric Power Corporation. It gave rights to purchase those stocks to its stockholders. Among those stockholders was United Founders Corporation. United Founders Corporation had then rights to buy some 990,000 shares. Those rights it waited with until the very last day on which rights could be exercised and then sold them to an affiliate for $5,000,000. Then the affiliate exercised the rights, as you can see by the broken line on the chart; it subscribed for the

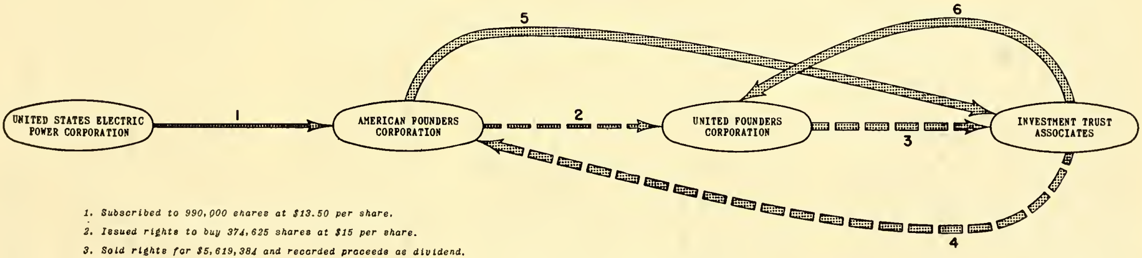
INTERCOMPANY TRANSACTIONS IN
INTERNATIONAL SECURITIES CORPORATION
OF AMERICA CLASS B COMMON STOCK



1. Purchased 20,000 shares at $8.62 per share.
2. Sold 5,000 shares at $25 per share, profit $81,900.
3. Sold 15,000 shares at $25 per share, profit $245,700.
4. Sold 7,000 shares at $30 per share, profit $35,000.
5. Sold 5,000 shares at $35.70 per share, profit $53,500.
6. Sold 8,000 shares at $35.70 per share, profit $85,600.
7. Sold 7,000 shares at $35.70 per share, profit $39,900.
8. Repurchased 20,000 shares at $35.70 per share, including a total of $541,600 intercompany profits beyond original cost of $172,400.

DS-1478

INTERCOMPANY TRANSACTIONS IN UNITED STATES ELECTRIC POWER CORPORATION RIGHTS AND COMMON STOCK



1. *Subscribed to 990,000 shares at $13.50 per share.*
2. *Issued rights to buy 374,625 shares at $15 per share.*
3. *Sold rights for $5,619,384 and recorded proceeds as dividend.*
4. *Tendered rights for exercise.*
5. *Rights exercised at $561,937 profit to American Founders Corporation.*
6. *Repurchased by United Founders Corporation for $11,276,212, including a total of $6,218,774.50 of recorded intercompany profits and income beyond initial subscription price.*

BS-1477

stock from American Founders, it exercised those rights, and then 3 days later sold them back to United Founders.

Well, United Founders recorded that it had made $5,000,000 profit in that transaction. It was not a profit of $5,000,000. They called those rights dividends and they were recorded on the books of American Founders as dividends, not even as investment profits. That was $5,000,000 by the mere process of passing it from one company and back again.

There were varying processes in these techniques. There were those two forms, one of selling to insiders on options far below the market; and the other form, that of running them around through the companies. Those two forms were forms by which United worked up this $46,000,000 profit. And I might add that the $46,000,000 does not include $5,000,000 of dividends I have just discussed. And that would have brought it up to $51,000,000 made out of these intercompany transactions.

I think one of the things important in connection with United Founders Corporation that complicates us as much as it probably did them, is this: There is something almost narcotic about these figures, so that they became almost meaningless to them.

Gentlemen, this question of the manipulation of profits assumed many forms and the techniques that were used were extremely skillful.

Frequently the profits would be routed to one company just at the end of the fiscal year, so that the report would look good. In other instances the profits would be routed to a company to sweeten a public offering that it was just about to make. Thus, in one transaction where Investment Trust Associates was just about to offer its stockholders rights to buy additional shares of its stock, profits of $2,700,000 were routed to it within 4 days prior to the issuance. The other companies in the group made $4,000,000 on the offer of the securities to other companies in the group, so that the transaction was very skillfully recorded and used at the time it was necessary to show the profit.

Witness after witness, when they were questioned on the stand, expressed emphatic disapproval, in retrospect, of what had happened, and one of them at least stated that he was astonished to find, although he was a director, that the transactions had had anything like this magnitude—in fact, several of the directors stated that they just did not know this kind of process was going on to anything like that extent.

Senator Wagner. Did any of those who so testified participate in these manipulations of profits?

Mr. Stern. Some of them did.

Senator Wagner. Were they surprised at their own manipulations? Is that what you mean?

Mr. Stern. I think, Senator, that a lot of people at that time had a notion that this was what was called an underwriting, although the essential difference between this and an underwriting was that they never assumed responsibility; for instance, in the General Investment Corporation case, between that spread of $12 and $30 there was not any binding subscription on the part of these gentlemen, and they did not take up other allotments until after a market had been established for about 15 days.

Senator Wagner. Did you ascertain whether or not the market was established by wash sales at all?

Mr. Stern. Senator, we got admissions from these gentlemen that the Founders companies were the dominant factors in the market. It was a comparatively small phase of the Founders investigation, so we did not go into the question of wash sales, but you can draw your own conclusions from these facts: In 1 year Founders General sold $400,000,000 of group securities and in the same year it bought $220,000,000 of securities. In the next year Founders bought back more than it sold. So that had it been important, I think we might have established pretty definitely, and I think the record leads to the sound inference, that the market was very much made by Founders General.

Of course, wash sales are not the only form of market manipulation.

Senator Wagner. No; they are a form.

Mr. Stern. They are a form.

Senator Wagner. I take it that since the establishment of the Securities and Exchange Commission it has become almost impossible now to manipulate in that way?

Mr. Stern. Probably so, where the Commission has jurisdiction.

Now, in order to make these profits, there, of course, had to be a very effective distributing organization, and it was the emphasis on distribution as much as anything else, I think that brought about the Founders' difficulties, because they found that they could raise money so easily, as one of the former officers of the company said, "the difficulty and the dilemma is that you can usually raise money at a time when it is least profitable to invest it"—that is, the easier it is to raise money, the harder it may be to invest it.

Therefore, there was no particular reason for creating the new company except the fact that they could raise money and there was great pressure on them to go from one enterprise into another and, also, the other pressure that it was lucrative to the insiders and essential for the making of their profits by the existing Founders companies to have this continual flow of capital.

Then there was one other feature in it. The very distribution, as you gentlemen will see on reflection, creates a vicious circle. Founders General was this wholly owned distribution concern and Founders General had a very heavy overhead. They had some 300 employees. In 3 years they had $5,000,000 of expenses. As Mr. Seagrave admitted on the stand, in order to keep that company you had to continue furnishing them with business, so that the thing became a vicious circle. The attention was taken off investments because of distribution. As distribution grew, it had to get even bigger in order to keep this corporation alive.

There was another factor in the distribution. I think all of them deplored the fact that a company might buy and sell its own securities, but they seemed to have no difficulty with a wholly owned subsidiary buying and selling the securities and sending the proceeds up to them as a kind of dividend, and that looked good on the balance sheet and income account.

Senator Wagner. Was that because it was a new name; or did you ascertain the reason why they could sell the stock more readily to the subsidiary?

Mr. Stern. They did not sell the stock to the subsidiary. American Founders, for instance, found it was not a very desirable thing for American Founders to buy and sell American Founders stock, but they though there would be no difficulty if Founders General, its wholly owned subsidiary, actually bought and sold American Founders stock,

and it had the disadvantage that Mr. Schenker spoke of in the other connection.

Instead of the entire price, if they were selling stock as capital of American Founders going in as capital, part of the price came to American Founders as a profit and could be distributed as dividends, again inflating the income account at the expense of capital account.

These gentlemen, the former officers and directors, were examined as to this feature of a wholly owned distributing concern, and witness after witness condemned it in no uncertain terms. They thought the effect upon American Founders had been disastrous, and they so testified. They also said that distribution was a business entirely different from investment. The preoccupation with distribution called for entirely different methods and entirely different techniques.

We have more or less touched upon the profits to the insiders. The insiders then had this big stake in making profits by forming new companies along with the Group, but the insiders became a little bit more audacious than that. They began trading. They began trading on margin.

There were two rather distinguished economists connected with this group. They formed their own trading company, bought and sold securities on margin. These economists, who were supposed to have this detached, fine investment judgment, began buying and selling for quick turns. The investment department, in 1929, according to their testimony, instead of being used for investment had their facilities frequently used to predict short turns in the market, and they used these short turns in order to try to make profits. They did not succeed and, of course, like everybody else, they lost on the short-term trading; but not only did the economists form their little separate company, by which they traded, and lost their shirts, incidentally, but the heads of the investment department also formed their separate company, which was financed by a favored broker of the company, and these investment heads likewise traded in large quantities in securities, both company securities and outside securities, and they likewise suffered heavy losses in the end.

The fact is, however, gentlemen, that all the time while the public was being given the picture of this conservative management making its investments with skill and detachment and on the basis of science, what they actually were doing was making the so-called profits for the company out of tricky distribution, and they themselves were preoccupied with similar "profits" of distribution and with their own personal trading.

As one of the witnesses said, everybody, from the bootblacks and the office boys up to the president of the company, traded. Everybody traded.

Therefore, the picture given to the public of skill and science and detachment was a very different picture from what was happening inside.

Senator Wagner. Of what years are you speaking now?

Mr. Stern. 1928 and 1929, Senator.

We might note one case where one of the officers, an officer of General Investment, had tradings which were fairly conspicuous. That company lost its shirt. It lost its shirt and practically everything else.

Senator WAGNER. I do not like to interrupt you, but I want to be informed on this. Was he trading with his own money and with his own securities or was he using the portfolio?

Mr. STERN. No; this was his own private enterprise. This man, who was a high officer in a company that lost $70,000,000 out of $78,000,000 paid in by the public, had succeeded in making, in trades of the preferred stock of that company, nearly $1,000,000—the actual figures are $941,000—and he did that between 1933 and 1937.

I think it is rather interesting that while the officers were trading they held out to the public that "the shares of American Founders Corporation are essentially an investment for the long pull, as they always had been. They should be owned outright and regarded as a relatively permanent investment. Market fluctuations may be ignored."

The general portfolio losses ran to $130,000,000, and undoubtedly some of this was caused by market declines, but not all of them. Some were caused by other transactions, which I will now go into very briefly.

As I said before, this story is so long that I will just take up briefly what happened in the case of the three largest losers: The General Investment Co., the United States Electric Power Corporation, and the United Founders Corporation.

As you gentlemen will recall, the advertising by the group emphasized that they were independent of investment bankers—in fact, the statement was made that United Founders and subsidiaries formed the largest independent group of the kind in the United States and that it is not dominated or controlled by any bank, investment banking house, or other institution.

Now, as stated, that might have been correct, but the fact is that they did proceed to put millions of dollars in affiliated companies which were controlled by investment bankers and with the disastrous results that I am now about to mention.

I asked, "Why did you advertise that you were independent of investment bankers? What did you fear?"

They said that they feared that the public might think that what had happened abroad might happen here.

Now, what had happened abroad was told in a book at the time. This book was written by Mr. Leland Rex Robinson, and Mr. Leland Rex Robinson had been an officer of one of the group companies—in fact, he had been president of the Second International Co. Mr. Robinson pointed out as an earlier evil in the British companies that there were connections with banking houses and that these banking houses were not above using these affiliated companies as a dumping ground for issues which the public failed to absorb.

Then Mr. Robinson added:

> It speaks much for the growth of professional ethics that in London a repetition of such practices seems hardly conceivable and an enlightened public opinion has fostered a position of greater independence among institutional investors holding investment trusts.

Let us see what happened to General Investment Corporation. The General Investment Corporation was formed with Harris Forbes. Harris Forbes had probably put out more securities than any other investment banker in the United States during that particular period. Members of Harris Forbes became officers of the General Investment Corporation. The General Investment Corporation was this com-

pany in which $78,000,000 was paid in and $70,000,000 was lost. The bankers were given control of this company, although the Founders group had the largest single interest in it.

Now, I think it will be probably as illuminating as anything else I can do to run briefly over some of the transactions that happened and the amount of the losses in those transactions.

The Associated Gas & Electric Co. is a company which recently has gone into bankruptcy, and Harris Forbes & Co. were the bankers for that company. Harris Forbes turned over its entire utility portfolio to General Investment Corporation. That was the start. Their entire utility portfolio was turned over to the General Investment Corporation.

Senator WAGNER. When you say "turned over," the General Investment Corporation must have paid for that?

Mr. STERN. Exactly, sir. I should have said that.

Senator WAGNER. Yes.

Mr. STERN. That is, Harris Forbes subscribed and the General Investment Corporation took the money and bought the investment portfolio of Harris Forbes.

Senator WAGNER. At the market price?

Mr. STERN. At the then market price, which was substantially in excess, apparently, of fundamental prices and asset value.

Among the securities that were taken over from Harris Forbes were 51,000 shares of common stock of Associated Gas & Electric, and they paid $3,000,000 for that, and the Associated Gas & Electric investment was later increased to $15,000,000, acting under the advice of Harris Forbes, with Harris Forbes being the Associated's banker at that time.

Of that $15,000,000, $14,437,000 was lost.

Then a more complex story, but I think we can follow it, is the case of the Central Public Service Corporation. Immediately after the formation of General Investment Corporation about 30 percent of the assets were invested in a utility, into the Portland Electric Power Co. So that General Investment then found itself in the possession of an electric company, but it had no particular facilities for running it.

It thereupon sold Portland Electric to Central Public Service, which was a holding company. Central Public Service was a banking client of Harris Forbes. Central Public Service raised the money to pay for Portland Electric Power in large part by a new issue of securities, which Portland Electric Power Co. put out.

This bond issue was an issue of $16,000,000 and that about doubled the oustanding indebtedness of Portland Electric Power.

Harris Forbes floated the bond issue. Both Portland Electric Power Co. and Central Public Service went into reorganization a few years after that. As a matter of fact, at the time Portland Electric Power Co. was sold to the General Investment Corporation, which was the group company, Portland Electric Power Co. was not in very good shape. It had been getting along, but not too well.

The ultimate loss in that transaction——

Senator WAGNER. Was that a bond issue of the Portland Co.?

Mr. STERN. No, sir. General Investment bought the stock of Portland Electric Power Co.; then turned over Portland Electric Power Co. to this other corporation, Central Public Service, the holding company, and then lost their shirts on the holding company.

Senator WAGNER. Did they buy the entire issue or did the public participate?

Mr. STERN. Well, Senator, perhaps there are two things that I ought to clear up about that. First, the General Investment Corporation bought the stock of the operating company, which was Portland Electric Power Co. Then Portland Electric Power Co. was turned over to Central Public Service, which issued its stock to General Investment Corporation. Is that clear?

Senator WAGNER. Yes.

Mr. STERN. Now, it was on that stock of Central Public Service that General Investment Corporation took its loss, but the way Central Public Service raised the money to finance its own affairs was to have the underlying company, the Portland Electric Power Co., float a bond issue, and that issue was sold to the public by Harris Forbes. That was part of Harris Forbes' banking business.

What actually happened in that was that the original investment was about $20,000,000; $8,000,000 cash was paid back by Central Public Service to General Investment Corporation, and that left them with a $12,000,000 investment in it. They ultimately got out of it $70,000.

Mr. Blumner reminds me that in discussing Associated Gas, which General Investment purchased from Harris Forbes, I had neglected to state that that stock had not cost Harris Forbes anything, but had been given to them when they undertook the banking business of the Associated system, and that, according to the Federal Trade report at the time, it was doubtful whether that stock had any asset value at the time it was taken over—in other words, that the write-ups in the Associated Gas & Electric were such that there was probably no value for the common stock, and there certainly is not any today.

Senator WAGNER. Well, Harris Forbes received how much for that stock?

Mr. STERN. $3,000,000, but they then got them to take further issues—either got them to take or advised them to take—of Associated Gas & Electric, so that the ultimate investment in Associated Gas & Electric was $15,000,000.

Senator WAGNER. You said this stock did not cost Harris Forbes anything.

Mr. STERN. That was only part of it, the part that cost $3,000,000.

Senator WAGNER. But Harris Forbes received $3,000,000?

Mr. STERN. Yes. It is fair to Harris Forbes to say that at that time there was perhaps a market which ostensibly justified that. Whether the market value truly justified that price, this record does not show.

There were certain European companies which I will quickly go over. There was the Westphalia Co. That company owed some money to the Deutsche Bank. The Deutsche Bank and Harris Forbes had gone into certain transactions together, and General Investment purchased half of a debenture issue there, and the loans that the company had borrowed from the Deutsche Bank and other banks were paid off, but the General Investment sustained a loss of $3,000,000 on a $7,000,000 investment.

The next situation was the Southwest Electric Co., which was a power company operating in Berlin. In that particular company Harris Forbes and a subsidiary of the General Investment Corpora-

tion, which was called the United States & Overseas, bought these debentures of this Southwest Electric Co.

The United States & Overseas, which was one of these group companies, and a subsidiary of the General Investment Corporation bought a $9,000,000 participation in the Southwest Electric venture, and they took over from Harris Forbes a participation of $1,800,000 additional.

Harris Forbes agreed to take back that $1,800,000 of debentures, on demand, but conditions did not improve in Germany and no one called on Harris Forbes to take it back, because the United States & Overseas was run by Harris Forbes' men, and General Investment Corporation was run by another Harris Forbes' man.

Harris Forbes had some technical defense, perhaps, to that commitment, but whether the defense was good or bad, no one will ever know, because Mr. Addinsell, of Harris Forbes, as vice president of the General Investment Corporation, drew up a contract with Mr. Granbery, of Harris Forbes, as president of the United States & Overseas, wherein they sold the commitment to the General Investment Corporation. The General Investment Corporation then took over the commitment and incurred the loss.

Senator WAGNER. Was that German company a government owned company, do you know?

Mr. STERN. No, sir. It had been originally, but it had been sold out.

Then there were investments in French companies, and all that need be said about it is that the loss in these investments, which were in electric utility companies, was $3,000,000 out of $4,000,000.

Finally, there was the situation of the South American Railways Co., and I would like to stress that a little bit. Later Mr. Schenker can finish the story on that, because the end of that story came in later years, but the South American Railways Co. had this situation: There was a subway in Buenos Aires and Harris Forbes had helped finance the preferred stock of the Terminal Co. that was interested in this subway. It became necessary to get construction funds, and Harris Forbes said to these gentlemen, "We will float an issue for you."

In the meantime the Guaranty Trust loaned the company the money to construct a subway, and the construction proceeded apace, and the Guaranty Trust began to get a little restless and from time to time it extended its loans, Harris Forbes stating, "We will float an issue of securities."

The October 1929 crash came and the loan was extended to December 1929.

Well, Harris Forbes never floated an issue of securities of the Terminal Co. At that time the Terminal Co. probably did not have sufficient credit to support the flotation of the issues, so what happened was that General Investment first loaned the money to pay off the Guaranty Trust and then later formed a new company called South American Railways, and South American Railways then issued securities which were guaranteed by General Investment.

Now, gentlemen, that involves so many companies that perhaps I had better make that clear again. What happened was that originally Harris Forbes had agreed to issue securities for the Terminal Co., but the Terminal Co. issues had no market, and, accordingly, Harris Forbes finally—the Harris Forbes' man being the president and the Harris Forbes' men being the majority of the board of directors of General Investment Corporation—had General Investment Corpora-

tion guarantee the bonds, and on that guaranty the securities were issued and Harris Forbes was relieved of this embarrassing commitment.

The proceedings did not turn out happily, however, for General Investment Corporation. General Investment Corporation lost $6,000,000 out of an investment of $14,000,000.

Senator WAGNER. You would not call that transaction a bail-out, would you?

Mr. STERN. Senator, it has the appearances of a bail-out.

Senator WAGNER. May I ask you if the General Investment Corporation is one of the corporations about which it was advertised that they were independent of investment bankers?

Mr. STERN. No, sir; that was not one of the corporations, but what they did advertise was that the United Founders group was independent.

Senator WAGNER. That was an affiliated company?

Mr. STERN. That was an affiliated company of the group.

In the case of General Investment Corporation, $53,000,000 of the $70,000,000 loss was incurred in investments in which Harris Forbes had some special interest either as banker or because securities had been in their subsidiaries or because they originally floated them or because they had a commitment—$53,000,000 loss out of $70,000,000 in securities in which Harris Forbes had some special interest.

At the conclusion of that hearing I asked Mr. Burroughs, who was a senior executive of Harris Forbes as well as president of General Investment.

Could you formulate for us, Mr. Burroughs, the reason why you don't think it is a good idea for investment bankers to be tied up to investment trusts?

Mr. Burroughs replied:

I think it is too difficult for any human being to be sure that he is protecting both classes of investors. I think he may be perfectly honest in his effort to be sure that he is dealing fairly with the investment trust, but I don't think it is possible for him to do it, and I think it is a bad idea for the investment bankers to have an investment trust affiliate.

I understand the law does not go quite as far as that. The law simply keeps control over the conflicting relationships and subjects such a relationship to the regulations of the Commission. Is that not correct, Mr. Schenker?

Mr. SCHENKER. There is only one correction, Senator. The bill which we hope will become a law has that provision in it.

Mr. STERN. That is a correction which I readily accept.

The loss in the General Investment Corporation was $70,000,000 out of $78,000,000, but the classic story of what happened in association with investment bankers comes in the United States Electric Power Corporation.

That was the corporation, which you gentlemen will see at the top of the right-hand side of the chart, which was formed a few days after General Investment Corporation, and in that corporation, gentlemen, $133,000,000 was invested, and at the end of the time $132 was all that was left of it.

Senator WAGNER. Which one is that?

Mr. STERN. The United States Electric Power Corporation.

Senator HUGHES. How was it invested?

Mr. STERN. I was going to tell you that, Senator. What they tried to do was to purchase the control of the Standard Gas System, and

they walked into what had been a fight for control. I take it that the time is so short that I cannot tell you much about this extraordinary fight for control, but what happened was that a group of investment bankers combined with Founders to put this money into this United States Electric Power Corporation, and Founders had the largest interest, and Founders finally had a controlling, majority interest.

United States Electric Power Corporation succeeded in purchasing a divided control with H. M. Byllesby & Co. of the Standard Gas System. But in order to get that divided control they had to spend more money than even $133,000,000, both in buying up Standard Gas and in finally buying out an outstanding interest, a New York firm called Todenberg-Thalmann & Co., and in order to do that they paid a huge sum of money and had finally to be carried along by the banks, put up all the stock of the company as collateral; and when they could not pay, the stock was sold out and United States Electric lost its entire portfolio.

The loss to the bankers was not so extensive in a way. The bankers bought back the stock on the sale and for a short time after the purchase of the controlling stock in the Standard Gas System the bankers received very substantial underwriting fees. I think in 1 year the underwriting fees from the system came to about $1,000,000.

That situation of United States Electric Power will be, I think, presented to you in a separate report. I should have liked, if time had permitted, to outline the story, which is really fantastic, because there had been for 5 years attempts by different firms in succession to get control of the Standard Gas System.

First there was the Byllesby concern, which is composed of Chicago bankers, and they tried to wrest away control of part of the system from Ladenberg-Thalmann. Ladenberg-Thalmann made $40,000,000 in profits, out of these attempts to wrest control away from it, and part of the time continued having the banking business. The $40,000,000 was absorbed by the Standard Gas system and by the United States Electric Power Co.

The first was Byllesby. Then came Lowenstein, the Belgian financier who finally came to his death in an airplane accident, and Mr. Lowenstein, with some other interests, among whom was Mr. Victor Emanuel, attempted to get a foothold in Standard Gas.

They did not succeed, and finally, through Mr. Riggs, who was the attorney for Founders, they came in contact with Founders, and then Founders, the Lowenstein-Emanuel interests, and some other banking interests that were brought in, formed the United States Electric Power Corporation.

Whatever the purpose was, there was no question about it that there were certain perquisites of control with an electric utility system as big as Standard, and I shall not go into that because you are familiar with it, but what the United States Electric Power Corporation did was to become a part of the fight for the control of Standard Gas & Electric Co. system.

When these gentlemen finally bought the control of it so that they owned control jointly with Byllesby, an action that was brought against Byllesby to account for the waste that Byllesby has made and the profits that were paid out was dropped, so that Byllesby was no longer liable for an accounting. They then divided the benefits of control up, but I do not think the United States Electric Power

Corporation got any of the banking business, because it did not have the facilities for the banking business, but I think they did retain the right to say who the bankers would be, and they designated as bankers their banking associates, so that the transaction bore all the earmarks of being a transaction that was undertaken to obtain the advantages of control, and the advantages of control were largely obtained by the bankers in the form of continued banking perquisites.

I wanted to tell you a little about United Founders. This United Founders was this concern at the top of the pyramid. It was formed so that the American Founders group would continue their same conservative management, as the circular put it. Out of the $300,000,000 paid in, $285,000,000 was lost.

Senator Wagner. That was nearly all of the public's money?

Mr. Stern. Yes. That brings up an interesting question. I think this shows it is an evil which is met by the bill.

What was done was this: You see, originally security holders invested in International, Second International, United States and British, and American and General. They were subsidiary investment trusts and they were run moderately conservatively, and their losses were under 50 percent. Whether that was a good record or not, their losses were under 50 percent.

The stockholders did not get the advantage of that. They were moved from these safer positions, first to American Founders, and then up to United Founders.

Thirty-three million dollars was moved up to American Founders by exchange offers, and then $139,000,000 of stock of American Founders was moved to the top company, United Founders. So that many stockholders did not share in the lesser losses of the companies in which they had originally invested.

With reference to these exchange offers by which security holders were moved from the lower companies to the top companies, this was not merely an exchange in which the men were left to exercise their judgment. They were not told that the asset value at terms of the securities which were offered in exchange for them was very much less than the asset value of the securities which were given up. Nor were they left to exercise their discretion, because pressure was being put on them. Brokers were hired and paid commissions to bring about these exchanges.

These were exchanges by which people in the lower, safe companies were moved to riskier positions, and finally a lot of them shared this 95 percent loss in the top company.

A great deal of that pyramiding would be taken care of in the bill, and, of course, the shifting of men from one company to another would be put under supervision. I understand that there is going to be brought up in detail before the committee—the accounting practices of the Founders Companies which concealed from the public what was going on.

The thought may have occurred to you gentlemen, "Why, this all seems pretty elementary. Why didn't the people know about it?" The fact is they used what were advertised as independent certified public accountants, and they used the name of the biggest accounting firm as a so-called consulting accountant, but despite the fact that these gentlemen were used and the public was told that they had the protection of these accounting firms, what actually happened was that the public failed to receive protection.

As you have seen, all of the so-called "profits" came from the inter-company transactions, but no one could tell that. When they did speak of them they called them investment profits, but they did not tell them what part of the investment profits was due to transactions in group——.

Senator FRAZIER. What did the accounting companies get out of it for keeping the thing covered up?

Mr. STERN. Substantial accounting fees. I do not believe they got any more, but the fact is, and that is one of the dangers of this thing, that it shows accounting firms of high reputation and distinction in the community just did not protect the public.

When they were asked on the stand about these practices they did not, of course, seriously defend them.

Now, there were certain other things designed for their protection——

Senator WAGNER. I think it would be interesting at this point to inquire as to why these accounting firms of reputation did not disclose to the public the accounting system which suppressed the truth, or were they deceived?

Mr. STERN. Senator, perhaps you had better draw your own conclusion from these two facts. I will just tell you them and you can draw your own conclusion.

Senator WAGNER. All right.

Mr. STERN. Mr. Leland Rex Robinson had written a book on investment trusts, and the book had been written on company time, and the book told what the proper accounting principles were, only the principles were not followed in this case, and they were not followed in the case of Mr. Robinson's company, the Second International.

Senator FRAZIER. I think some accountants must be like some attorneys—they will do what they are told to do if they are paid.

Mr. STERN. Senator, a lot of people did a lot of things in 1929.

Mr. FRAZIER. Yes; I know.

Senator WAGNER. But you spoke of some dates after 1929. Some of those transactions came after that date.

Mr. STERN. 1929 and 1930, but the fact that the accountants did not do their work is shown by other transactions too.

I am not holding any brief for the accountants. I do not know whether their kind of morality that went into this was higher or lower than the prevailing level. It was rather low, if this is a fair example; I have no way of telling however.

I do not want to go into the details of that, because I understand Mr. Schenker wants to go into that as part of another hearing, but I wanted to tell why it was that these enormous profits could have been concealed not only from the stockholders but from the directors, so that director after director admitted his astonishment.

Then there were other things that were seemingly for the protection of investors. There were some fairly big names, as on the directorate. The directors on the whole—a great many of them—just did not know what was going on, I think, because the concern was run in a group, consisting of Coombs, Erwin, and Seagrave.

For the protection of the stockholders there were these restrictions that were advertised from time to time. I have told you of some that were advertised. Others were advertised and actually evaded, for restrictions could be easily evaded. For instance, I told you that

one company could only buy seasoned securities, defined as a company that had been in existence for 4 years. How did they get around that? There wasa company that one of them owned, and it had been operating for 4 years. They did not sell the company. They sold the name. They took out all the assets and securities and they treated it as a new company, and that was one of the ways they evaded that.

Another way was that since it was a restriction in the bylaws, the bylaws were changed.

Still another way you could get around a restriction, as they did here, was to move the public by exchanges from the restricted companies to the unrestricted companies, and the restrictions were not of very much use to them then.

Senator WAGNER. The brokerage fees are perfectly legitimate if paid in a legitimate way. Were there insiders that received these fees in these transactions?

Mr. STERN. I think the brokerage fees, while they might have been fairly large, were fairly clean, but that was not a large matter compared with the others.

Just another word and I will complete my statement. I would like to quote for a minute from Robinson's book, because it seemed to me, after I had found out that one safeguard after another designed for the protection of the stockholders had failed, it was curious to note what Dr. Robinson had said.

He said that one of the evils of the British investment trusts was—

> The struggle to enhance earnings and increase dividends even by devious processes during times of rapidly accumulating capital and of multiplying security prices. Endeavor to realize trading profits led companies into transactions which would be universally condemned today as too unsound in character to warrant serious consideration on the part of responsible investment trusts.

Then Dr. Robinson continued in language which is curiously reminiscent, now, of what Founders actually did:

> In order to realize profits from financing, dealing, issuing, and underwriting, several companies spawned flocks of new ones engaged in a vairety of promoting, financial, and investment activities, and creating a pryamid of paper values.

That, Robinson said, was the thing that had happened in British investment trusts and the thing that could not happen again today. That is exactly what did happen in Founders, and may I say that faced with the fact that this gentleman knew what had happened in the British trusts and the same thing happened over here, I thought it might be useful, for the sake of the record, to ask witnesses whether they thought these large pools of investment funds should go unregulated, and these witnesses were officers and directors of the Founders Group, and every one of the witnesses who was asked the question said that there should be regulation.

Senator WAGNER. May I ask one final question? You have read the bill that is pending now?

Mr. STERN. Yes.

Senator WAGNER. And you have had the experience that you just related to us. Is it your opinion that this legislation, if enacted into law, would prevent very considerably the manipulations you have related here, so that the public would be protected?

Mr. STERN. Senator, I have given very careful consideration to it for the last few days, and I think it may safely be said that while honesty in the last analysis is the only thing that really tells, this

legislation will go a great distance to prevent the kind of thing that happened in the Founders system; that fundamentally it will prevent or put under supervision—and that is the only place where you can actually prevent it—the possible breaches of fiduciary relations; that the great fault in Founders was the transactions between companies; and that they will be substantially averted by putting them under regulation.

There is another point, too, about regulation that nothing else can accomplish, and that is the fact that although restrictions fail one after another—and you have seen how easy it is to avoid restrictions—the flexibility of the administrative process is such that a commission charged with the general duty of preventing violations of the fiduciary relation can chart and follow the various forms in which these violations might otherwise occur.

Senator WAGNER. Is it your opinion, as I read in various editorials, that the legislation, when one considers the abuses that have been disclosed, is very mild?

Mr. STERN. I think, Senator, in certain places it might have been heavier. For instance, the very officers of the corporation said that there should be no such thing as a wholly owned distributing company. The legislation does not go that far.

Others have said that there should be no such thing as a banker control of companies.

Senator FRAZIER. Can you tell us how Great Britain cleaned up the situation over there that Dr. Robinson described in his book?

Mr. STERN. I should like to do that, but I do not really think I can, because I do not know. I had nothing to do with that part of it, and my knowledge is so skimpy on that point that I would hate to try to tell you about it.

Senator WAGNER. Perhaps Judge Healy can tell us.

Mr. HEALY. We will have someone who knows about the subject speak about that.

I would like to call attention with respect to something Mr. Stern mentioned. I would like to call attention to the fact that this bill sets up accounting controls, and this kind of accounting for these pseudo, make-believe profits, that were not profits at all, could not happen under any rational system of accounting control by any regulatory body or by classification of accounts.

I think that the accounting control that is provided for in this bill would be very effective to prevent the repetition of a thing like the Founders.

May I say one other word?

Senator WAGNER. Certainly.

Mr. HEALY. I have here—I do not offer it for the record necessarily—a copy of the Commission's opinion in the matter of H. M. Byllesby & Co., where the Commission denied Byllesby's application for an exemption as a holding company as a result of what happened with regard to the Standard Gas & Electric.

I call attention to it because if any of the committee is interested in getting the further history of the relationships between the investment bankers and the companies in the Standard group, they can get from this opinion—that is, I think it goes a long way toward demonstrating that the interest of the investment bankers in combining with the United Founders and the United States Electric Power Corporation to get a strong position in Standard Gas & Electric was actuated by

a desire to get the underwriting business of the Standard Gas & Electric subsidiary companies.

There was a company of about a billion dollars—a consolidated balance sheet—and these investment bankers, after this situation that Mr. Stern described, had divided up the banking business in percentages that were actually established in a written contract that is described in this opinion.

Senator WAGNER. I think perhaps the entire opinion ought to go into the record.

Mr. HEALY. Very well.

(The document referred to is as follows:)

[For Immediate Release Monday, January 15, 1940.]

Securities and Exchange Commission, Washington. In the Matter of H. M. Byllesby & Co. and The Byllesby Corporation, File Nos. 31-379 and 31-420. Findings and Opinion of the Commission

[Public Utility Holding Company Act of 1935, sections 2 (a) (7), 3 (a) (3), and 3 (a) (5)]

Appearances.—Gerhard A. Gesell and Sanford L. Schamus, for the Public Utilities Division of the Commission; Herbert H. Thomas, for H. M. Byllesby & Co. and the Byllesby Corporation.

H. M. Byllesby & Co. and the Byllesby Corporation have filed separate applications under section 2 (a) (7) of the Public Utility Holding Company Act of 1935 (hereinafter referred to as the "act") for orders declaring that each is not a holding company under clause (A) of that subsection. In the alternative, the applicants have requested that the Commission should find that they are exempted from the provisions of the act under sections 3 (a) (3) and 3 (a) (5) thereof.

Section 2 (a) (7) (A) defines the term "holding company" for purposes of the act to mean—

"any company which directly or indirectly owns, controls, or holds with power to vote 10 per centum or more of the outstanding voting securities of a public-utility company or of a company which is a holding company by virtue of this clause or clause (B), unless the Commission, as hereinafter provided, by order declares such company not to be a holding company; * * *."

Section 2 (a) (7) further provides:

"The Commission, upon application, shall by order declare that a company is not a holding company under clause (A) if the Commission finds that the applicant (i) does not, either alone or pursuant to an arrangement or understanding with one or more other persons, directly or indirectly control a public-utility or holding company either through one or more intermediary persons or by any means or device whatsoever, (ii) is not an intermediary company through which such control is exercised, and (iii) does not, directly or indirectly, exercise (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that the applicant be subject to the obligations, duties, and liabilities imposed in this title upon holding companies." [1]

H. M. Byllesby & Co. (hereafter called "Byllesby") is a Delaware corporation with principal offices in Chicago, Ill.; and branch offices in New York City, Philadelphia, Pittsburgh, and Minneapolis. Its primary business is the underwriting and distribution of security issues. Since 1930, Byllesby has owned 330,000 shares [2] of common stock, series B, out of a total of 440,000 shares, of Standard Power & Light Corporation (hereafter sometimes referred to as "Standard Power"), a holding company which is registered under the act. Standard Power, in turn, holds the majority of the common stock of Standard Gas & Electric Co. (hereafter sometimes referred to as "Standard Gas"), another regis-

[1] The section likewise provides that the filing of an application thereunder in good faith shall exempt the applicant from any obligation, duty, or liability as a holding company until the Commission has acted upon the application. It is also provided in this section that as a condition to the entry of an order granting any such application, the Commission may require the applicant to apply periodically for a renewal of such order and do or refrain from doing various specified acts in order to insure that the conditions of clauses (i), (ii), and (iii) of the quoted paragraph are satisfied.

[2] Since November 9, 1936, Byllesby's ownership has consisted of a voting trust certificate representing said shares issued pursuant to a voting trust agreement hereinafter described.

tered holding company, and the dominant company in one of the largest electric utility systems in the United States.[3]

The Byllesby Corporation is the parent of Byllesby. It holds 217,622 shares out of the 398,592 outstanding shares of class B common stock of Byllesby, or approximately 55 percent of the total voting stock.[4] The Byllesby Corporation is a "shell" holding company; its sole function is to hold a majority of the voting securities issued by Byllesby, and thereby perpetuate the control of the latter company by its officers, directors, and persons closely affiliated with them.[5] Since the Byllesby Corporation admittedly controls Byllesby, disposition of its application turns upon our determination of whether Byllesby is a holding company within the meaning of section 2 (a) (7). If Byllesby is a holding company it is clear that the Byllesby Corporation is likewise a holding company under the statutory definition.

It is obviously impossible to comprehend the present relation of Byllesby to Standard Power and Standard Gas unless we undertake to examine the relationships previously existing between those companies. Accordingly, we briefly consider some of the relevant historical facts.

The predecessor to Byllesby, carrying same name, organized the Standard Gas & Electric Co. under the laws of Delaware in 1910. In return for the transfer to Standard Gas of utility properties previously acquired by Byllesby's predecessor company, Standard Gas transferred to it a majority of the voting stock of the company. From that time until 1930, Byllesby's predecessor and Byllesby, through ownership of voting securities, interlocking directors and officers, and otherwise, completely dominated Standard Gas and its subsidiaries.

Control of Standard Gas enabled Byllesby to guide the financial policies of Standard Gas and its subsidiaries and to obtain for itself primary participation in the underwritings of their securities. Byllesby's investment banking functions greatly expanded during this period; the growth of this phase of its business was largely commensurate with the increase in number and amount of security issues by Standard Gas and its subsidiaries.

Throughout this period, Byllesby, by virtue of its denomination of Standard Gas, caused Standard Gas and its subsidiaries to enter into transactions involving the purchase and sale of utility properties and securities, which netted Byllesby large profits. Through affiliated management corporations Byllesby likewise profited from charges for engineering, construction, legal and similar services to Standard system companies. The evidence taken before the Federal Trade Commission in its comprehensive study of the utility industry sets forth in detail a large number of these transactions.[6] Illustrative of these transactions is the acquisition by Standard Gas of a controlling interest in the Philadelphia Co. and affiliated corporations. For negotiating this transaction, Byllesby and Ladenburg, Thalmann & Co., a banking concern which previously controlled the Philadelphia Co., obtained a profit of over $16,000,000.[7] Of this sum, Byllesby received over $4,000,000. Apparently, Ladenburg, Thalmann & Co.'s enormous profit represented the price paid for surrendering partial control of the Philadelphia Co. system to the Byllesby and Standard Gas interests.[8]

By September 1929, other interests including a number of investment bankers had accumulated substantial quantities of the common stock of Standard Gas, with the purpose of obtaining a voice in the management of that company. These interests included United Founders Corporation, American Founders Corporation, Hydro-Electric Securities Corporation, Harris Forbes & Co., W. E. Langley & Co., A. C. Allyn & Co., Inc., Victor Emanuel, Thomas A. O'Hara, J. Henry Schroder Banking Corporation, and the Seaboard National Corporation Thereupon, these interests pooled their stock in the United States Electric Power Corporation, a Delaware corporation (hereinafter sometimes referred to as U. S. E. P.), which they organized. There ensued what the lare R. J. Graf, formerly president of Byllesby, described as "a real fight for control" between Byllesby and the interest for which U. S. E. P. spoke, which endangered the banking position theretofore enjoyed by Byllesby. By the end of 1929, U. S. E. P.

[3] It was conceded that the applicants, Standard Power, Standard Gas, and their subsidiaries make use of the United States mails in the conduct of their daily business, and that certain of the subsidiaries of Standard Gas transmit electric current across State lines.

[4] Byllesby has issued and outstanding 60,012 shares of preferred stock, 458,380 shares of class A common stock, and 398,592 shares of class B common stock. The class B stock alone carries full voting rights.

[5] The stock of the Byllesby Corporation is closely held. Its management stock, the only class having full voting power, is owned entirely by 7 individual stockholders. The common stock is held by about 30 individual stockholders.

[6] The facts set forth on pp. 261 to 663, inclusive, of p. 36 of the Federal Trade Commission Report (S. Doc 92, 70th Cong., 1st sess., (1931)) were introduced into the record without objection.

[7] Federal Trade Commission Report, supra, p. 36, p. 432.

[8] See Examiner Thomas W. Mitchell's report, in Federal Trade Commission Report, supra, p. 36, p. 433.

was in possession of 580,000 shares of Standard Gas common stock accumulated by its sponsors and itself at costs ranging from $60 to $245 per share. A pending suit brought by the sponsors of U. S. E. P. threatened Byllesby with cancelation of substantially all of the voting securities of Standard Gas held by Byllesby. The result of the fight for control was an agreement between the conflicting interests, involving among other things, a recapitalization of Standard Power and Standard Gas and the allocation among the parties of specified percentages in future underwritings of securities in Standard Power, Standard Gas, and their subsidiaries.[9]

As a result of the agreement, Standard Power, which had previously been a subsidiary of Standard Gas, was transformed into the parent of Standard Gas, holding a majority of its voting securities.[10] Standard Power thereby replaced Standard Gas as the top holding company in the Standard system. The certificate of incorporation of Standard Power was amended to reclassify its common stock into two classes of stock: Common stock, and common stock, series B. The common stock, series B, was empowered to elect a minority of the board of directors of Standard Power, but these minority directors, designated class B directors, were authorized to vote the common stock of Standard Gas held by Standard Power to elect a majority of the directors of Standard Gas. On the other hand, the common stock of Standard Power was authorized to elect a majority of the board of directors of Standard Power, which directors in turn could vote the common voting stock of Standard Gas to elect only a minority of the latter's directors. Byllesby emerged from the readjustment with 330,000 shares out of 440,000 outstanding shares of common stock, series B. Accordingly, as a result of this complicated arrangement, Byllesby retained the power to elect a majority of the board of directors of Standard Gas.[11]

As a part of the general settlement resulting in the foregoing readjustments, Byllesby and U. S. E. P. entered into an understanding [12] which was reduced to a detailed formal memorandum, relative to the extent and character of each party's participation in future financing of the Standard system companies. In general, the memorandum (hereafter called the bankers' agreement) provided that future financing by Standard system companies should be allocated as to interest and liability on the basis of 25 percent to Byllesby and 75 percent to U. S. E. P.[13] In the main, this apportionment corresponded with the relative stock interests of Byllesby and U. S. E. P. in Standard Power. Provision was made that if other banking houses were invited to participate in the underwriting of securities of Standard system companies, the amount permitted to the outsiders would, with certain designated exceptions, be deducted proportionately out of the 75 percent interest of U. S. E. P. and the 25 percent interest of Byllesby. The memorandum likewise contained detailed provisions concerning position and leadership in the underwriting of securities issued by the various companies in the Standard system.

The stockholdings of U. S. E. P. and Byllesby remained constant from the time the foregoing understanding was reached until June 1, 1936. During that period, 23 issues of securities were distributed by Standard system companies. In each instance, the underwriting was in accordance with the terms of the bankers' agreement. Thus, in each of the 10 issues distributed during that period in the underwriting of which no outside bankers were invited to participate, Byllesby received 25 percent of the underwriting and the U. S. E. P. bankers received 75 percent. Where outside bankers were permitted to participate, deductions from the amounts allotted to Byllesby and U. S. E. P. generally followed the terms of the bankers' agreement. Similarly, there was complete adherence to the provisions of the bankers' agreement with respect to position and leadership in each underwriting.

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[9] Standard Power, Standard Gas, and their subsidiaries when considered as a group, are sometimes referred to hereafter as Standard system companies.

[10] As a result of the readjustment, Standard Power held 1,160,000 shares out of 2,162,607 shares of Standard Gas common stock, the sole voting stock.

[11] After the readjustment, U. S. E. P. held 1,210,000 shares out of 1,320,000 outstanding shares of common stock of Standard Power. This enabled U. S. E. P. to elect a majority of the board of directors of Standard Power and a minority of the board of directors of Standard Gas.

[12] A third party to this understanding was Ladenburg, Thalmann & Co., which as stated above, had previously exercised joint control with Byllesby over the Philadelphia Co. and its subsidiaries. The Philadelphia system had been acquired by Standard Power prior to 1929 under an understanding by which Byllesby and Ladenburg, Thalmann & Co. exercised joint control through Standard Power. Ladenburg, Thalmann & Co. had participated with Byllesby in underwritings of the Philadelphia Co. and subsidiaries. Under the bankers' agreement, Ladenburg, Thalmann & Co. retained certain rights to participate in underwritings of the Philadelphia Co. system.

[13] The percentages differed in the case of underwritings of securities of the Philadelphia Co. and its subsidiaries in order to enable Ladenburg, Thalmann & Co. to continue to participate in underwriting the securities of those companies.

The common stock of Standard Power owned by U. S. E. P. was sold in June 1936; the major portion was acquired by a group of investment bankers which included many of the bankers who had been connected with the management of U. S. E. P.[14] As of the last record date for the determination of stockholders entitled to vote at annual stockholders' meetings of the corporation, there had been no change in the holdings of Standard Power stock by these investment bankers.

It is clear that as of November 9, 1936, Byllesby by virtue of the direct ownership of 330,000 shares of common stock, series B, of Standard Power, which enabled it to elect a majority of the board of directors of Standard Gas, effectively controlled the latter company and all of its subsidiaries. The ownership of such stock also enabled it, in conjunction with the bankers, to control Standard Power. Under these circumstances, the act required that Byllesby register as a holding company. To obviate that requirement, and to avoid the duties which the Act imposes upon registered holding companies, Byllesby sought to alter its relationship with the Standard system companies.[15] To that end, it caused officers and directors of Byllesby and The Byllesby Corporation who held positions in any of the Standard system companies to resign from their conflicting positions, and on November 9, 1936, it entered into a voting trust agreement with three voting trustees concerning the Standard Power common stock, series B. In accordance therewith, Byllesby transferred its 330,000 shares of common stock, series B, of Standard Power to the voting trustees, and received in return a voting trust certificate.

In most respects the voting trust agreement is not novel. It is, however, unusual in that, while it purports on its face to be an agreement between the voting trustees and all holders of the common stock, series B, of Standard Power, it provides that no holder can deposit his shares thereunder without the prior permission of Byllesby. The power to bar the entry of outside stockholders renders the voting trust virtually a closed trust between Byllesby and the voting trustees. The life of the voting trust is fixed at 10 years "unless sooner terminated in accordance with law."

The initial voting trustees were Bernard W. Lynch, Henry C. Cummins, and Matthew A. Morrison. These persons had been closely connected with Byllesby and the Byllesby Corporation for many years prior to their selection. Cummins had served as a director of Byllesby from 1919 to 1931 and of the Byllesby Corporation from 1925 to September 14, 1938. Morrison had intermittently served as vice president, treasurer, and member of the executive committee of Byllesby from 1914 to October 27, 1936; he likewise served as secretary and treasurer of the Byllesby Corporation from 1925 to 1936. Lynch joined the Byllesby organization in 1905, and at various times until September 1936 served as vice president and director of Byllesby and vice president and director of the Byllseby Corporation. Prior to becoming voting trustees, those persons resigned from their various positions in Byllesby and the Byllesby Corporation and surrendered their management stock in the latter. All of them, however, retained substantial interests in the common stock of the Byllesby Corporation.[16] The long business association of these trustees with Byllesby and their evident interest in the affairs of Byllesby were factors which unquestionably prompted their selections. It was stated at the hearing that the voting trustees accepted their positions as an accomodation to Byllesby.

In September of 1935 Standard Gas filed a voluntary petition for reorganization under section 77B of the Bankruptcy Act in the United States District Court in Delaware. By order of the court the debtor was permitted to continue in possession. Thus the pendency of the reorganization proceeding did not materially alter the management of that company. Oh March 5, 1938, the court confirmed a plan of reorganization [17] of Standard Gas, which involved, among other things, a diminution in the voting power of the company's common stock. Therefter, the common stock could elect only four out of nine directors; the holders of the prior preferred stock and the $4 cumulative preferred stock were empowered to elect two directors each, and the registered holders of outstanding notes and debentures were authorized to elect one director.

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[14] J. Henry Schroder Banking Corporation, Emanuel & Co., W. C. Langley & Co., and A. C. Allyn & Co., Inc., all of whom had been among the bankers connected with the management of U. S. E. P. retained, by direct purchases, interests in Standard Power which they had previously held through U. S. E. P. Bancamerica Blair Corporation, which had not been previously interested in U. S. E. P., took a large interest in Standard Power, and Granberry, Safford & Co., also new to the picture, took a smaller interest.

[15] Byllesby further stated that it desired to alter its relationship with the Standard system in order that it might not be prejudiced in obtaining participation in the underwriting of issues of other utility companies

[16] Lynch held of record 9,850 shares of the Byllesby Corporation common stock; Morrison, 14,993 shares and Cummins, 2,000 shares. In addition, Morrison and Cummins owned small amounts of Byllesby stock.

[17] Technically it was a reorganization; actually it made very few changes of importance.

The record discloses that there has been one election of directors of Standard Gas since confirmation of the plan of reorganization. At that time, Standard Power, as owner of a majority of the common stock of Standard Gas, elected the four directors to which common stock as a class is entitled. Standard Power was, of course, merely speaking for the interests which controlled it, the investment bankers who held its common stock and the voting trustees for the common stock, series B, owned by Byllesby. In addition, it appears that a fifth director, John K. McGowan, was in effect the nominee of these bankers; McGowan, a close associate of Emanuel & Co., was elected pursuant to the nomination of a $4 preferred stock committee which was under the influence of those bankers.[18]

Mr. Cummins resigned as one of the voting trustees on June 10, 1938, 5 days prior to the commencement of the hearings before the trial examiner.[19] Messrs. Lynch and Morrison continued as voting trustees until the hearings were concluded on July 20. On August 1, 1938, Mr. Morrison resigned. On September 8, 1938, Mr. Lynch, the sole remaining trustee, appointed George F. Doriot and Henry E. Triede, both of whom are asserted to have had no previous connections with Byllesby, to fill the vacancies caused by the resignations of Cummins and Morrison.

Although the hearings before the trial examiner had been closed in July, the Commission, pursuant to request of the parties, ordered that the hearing be reopened on October 5, 1938. Mr. Lynch resigned on October 1, 1938, just before the reopened hearing. The vacancy caused by his resignation had not been filled at the time the record was finally completed.

The evidence at the reopened hearing was directed to the question of the independence of the new trustees. Both of the new trustees testified that because of their short period of service, they had performed no duties as voting trustees. Accordingly, the sole evidence that could be introduced on the issue of independence related to their method of appointment and their conception of a trustee's duties.

Thus, with the exception of the scanty evidence relating to the independence of the new trustees, the whole case was heard before the trial examiner on the facts as they existed prior to, and during the tenure of office of the original voting trustees.

Upon the basis of facts contained in the record, it appears that the interposition of the voting trust has in no way adversely affected Byllesby's participation in the underwriting of securities of Standard system companies. Four issues have been offered to the public since the creation of the voting trust on November 9, 1936. Byllesby has substantially participated in the underwriting of each of these issues. Other members of the original banking group who had purchased the Standard Power common stock from U. S. E. P. likewise participated in the underwriting of these security issues. In addition, Bancamerica Blair Corporation,[20] which was not a party to the original bankers' agreement, but which had purchased a substantial block of Standard Power common stock from U. S. E. P., ascended to a primary position in the financing of the Standard system companies, even though previous to its purchase of Standard Power stock

[18] Control over protective committees by management and bankers is not unusual. The manifold types of such control, the ways in which it is and has been exercised, and some of the abuses resulting therefrom are described in pt. I of our Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1937) made pursuant to sec. 211 of the Securities Exchange Act. That the desire of Byllesby and its affiliated banking interests to perpetuate their control through domination of committees is not unusual is shown by the following quotations from this report (p. 873):

"Inside groups, seeking control over the reorganization process, move quickly to gain control over protective committees. Such control is important mainly in that it enables the inside group to obtain the apparent support of security-holders behind its program. The management and bankers of the debtor company are thus able to remain in the background, exerting their influence through protective committees which ostensibly represent the various classes of securities and other claims involved in reorganization. Control over committees facilitates control of legal proceedings, whether such proceedings take the form of receivership or bankruptcy. It also insures to the inside group control over the negotiation of the reorganization plan, control over committee patronage, and a certain amount of control over investigations and litigation concerning the past conduct of the management and the bankers.

"The formation of protective committees has long been regarded a prerogative of the inside group."

And on pp. 875-876:

"Many examples of banker-management selection of committees appear in the various parts of our report. Even the absence of such affiliations by no means precludes the possibility that committee members have been selected by and represent the inside group. Nor need the latter lack influence though few or none of its representatives are on the committee. Inside groups may exert control over committees by financing their operations as well as by selecting their members. Committees dependent upon the debtor company or its bankers for their financial support are not likely to take action adverse to those interests. In sum, the prevailing pattern of reorganization is that the bankers and management have dominated the selection, and by and large, the policies, of protective committees."

[19] Mr. Cummins assigned as the reason for his resignation the fact that he and his brother had in May 1938, inherited additional holdings in common stock of the Byllesby Corporation amounting to approximately 20,000 shares. and suggested that his continued service as a voting trustee might result in serious personal embarrassment.

[20] Since the filing of the application herein, the name of this firm has been changed to Blair & Co., Inc.

it had never actively participated in such financing. Bancamerica Blair Corporation's sudden participation in Standard financing is illustrative of the exertion of stockholder control to the end of distributing the underwriting among the stockholders in approximate proportion to their holdings.

Against this background, we turn to a consideration of the question whether Byllesby is entitled to a declaration that it is not a holding company within the meaning of section 2 (a) (7) (A) of the act.

At the oral argument before the commission, counsel for the applicants argued that Byllesby was not even prima facie a holding company under section 2 (a) (7) (A), for the reason that while it was the beneficial owner of the 330,000 shares of common stock, series B, which it had deposited with the voting trustees, it did not own those securities "with power to vote." It was urged that the language of Section 2 (a) (7) (A)—"holding company means any company which directly or indirectly owns, controls, or holds with power to vote, 10 per centum or more of the outstanding voting securities of a public utility company or of * * * a holding company"—embraces only situations where a company directly or indirectly owns with power to vote. controls with power to vote, or holds with power to vote, 10 percent or more of the designated securities.

Regardless of the appropriateness of considering, on an application of this character, whether Byllesby is prima facie a holding company, we are convinced that the construction of section 2 (a) (7) (A) for which counsel for the applicants contends, is untenable. The punctuation of that subsection makes it clear that the phrase "with power to vote" qualifies only the word "holds," and not the words "owns" or "controls." While commas appear after the words "owns" and "controls," the word "holds" which immediately precedes the phrase, "with power to vote," is not separated from that phrase by a comma. The punctuation, we believe, merely gives expression to the congressional purpose of preventing easy avoidance of the statutory definition by model arrangements which do not materially alter the status of companies owning or controlling voting securities of a public utility or holding company.

Section 2 (a) (17) which defines the term "voting security" points to the same conclusion. That section provides in part:

" 'Voting security' means any security presently entitling the owner or holder thereof to vote in the direction or management of the affairs of a company, or any security issued under or pursuant to any trust, agreement, or arrangement whereby a trustee or trustees or agent or agents for the owner or holder of such security are presently entitled to vote in the direction or management of the affairs of a company * * *."

Under this statutory definition, it is clear that ownership of voting trust certificates constitutes ownership of "voting securities" within the meaning of the act. Accordingly, the beneficial ownership of 330,000 shares of common stock, series B, of Standard Power, a registered holding company, which comprises more than 10 percent of the outstanding voting securities of the latter company, renders Byllesby prima facie a holding company under section 2 (a) (7) (A).

It is clear, therefore, that Byllesby is a holding company within the definitions of the act, unless we are able to find, in accordance with section 2 (a) (7), that it "(i) does not, either alone or pursuant to an arrangement or understanding with one or more other persons, directly or indirectly control a public-utility or holding company either through one or more intermediary persons or by any means or device whatsoever, (ii) is not an intermediary company through which such control is exercised, and (iii) does not, directly or indirectly, exercise (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that the applicant be subject to the obligations, duties, and liabilities imposed in this title upon holding companies." All three conditions, it will be noted, must exist before we may enter an order declaring a company not to be a holding company under clause (A).

In our opinion, the applications under section 2 (a) (7) cannot be granted for want of a showing that condition (iii) has been satisfied. Since our inability to find that the latter condition has been met precludes our declaring, on the facts now before us, that applicants are not holding companies under clause (A), we deem it unnecessary to decide whether the first two of the quoted conditions have been met.

The term "controlling influence" which is employed in section 2 (a) (7) is not defined in the act. We must, therefore, interpret the term in its statutory context and in the light of its legislative history and decisions of the courts dealing with somewhat analogous provisions.[21]

It seems clear that Congress meant by the term "controlling influence" something less in the form of influence over the management or policies of a company, than "control" of a company. For, while the existence of "control" constitutes an absolute bar under clause (i) of section 2 (a) (7) to the entry of an order declaring a company not to be a holding company under clause (A), the existence of a "controlling influence" precludes such an order only if it is "such a controlling influence * * * as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that the applicant be subject to the obligations, duties, and liabilities imposed in this title upon holding companies."

We deem it equally plain that the form in which a "controlling influence" is exercised is unimportant; it is the fact of "controlling influence" rather than the device employed to achieve that end that is important. Thus it is stated in the House of Representatives Committee Report (74th Cong., 1st sess., 1935, H. R. Rep. No. 1318, p. 9), that flexibility

"* * * is necessary in order that title I can meet the varied and subtle forms which corporate interrelationships have in the past and will in the future take."

Moreover, the existence of a "controlling influence" is not dependent upon the possession of a majority of the voting stock of a company. In *United States* v. *Union Paicfic R. R. Co.* (226 U. S. 1 (1912)), it was held that possession by the Union Pacific Railroad Co. of about 48 percent of the stock of the Southern Pacific Railroad Co. assured the former company "control" over the latter, and subjected it to the Sherman Act. The following language from the opinion is apposite:

"But it is said that no such control was in fact obtained; that at no time did the Union Pacific acquire a majority of the stock of the Southern Pacific, and that at first it acquired but thirty-seven and a fraction percent which was afterward somewhat increased and diminished until about 46 percent of the stock is now held. In any event, this stock did prove sufficient to obtain the control of the Southern Pacific. It may be true that in small corporations the holding of less than a majority of the stock would not amount to control, but the testimony in this case is ample to show that, distributed as the stock is among many stockholders, a compact, united ownership of 46 percent is ample to control the operations of the corporation" (p. 95).

More recently in *Natural Gas Company* v. *Slattery* (302 U. S. 300 (1937)), the Supreme Court, in sustaining an inquiry by the Illinois Commerce Commission into the contractual relationships between affiliated companies, pointed out that "control" may exist under circumstances other than the ownership of a majority of voting stock. In that case it was contended that the Illinois Public Utility Act was unconstitutional in that it authorized investigation of, and required reports from, "affiliated interests" without definite proof of actual control or want of arm's-length bargaining. The Supreme Court rejected this contention and sustained the Illinois statute. On the particular question of control, the Court said at pages 307–308:

"We have not said, nor do we perceive any ground for saying, that the Constitution requires such an inquiry to be limited to those cases where common control of the two corporations is secured through ownership of a majority of their voting stock. We are not unaware that, as the statute recognizes, there are other methods of control of a corporation than through such ownership. Common management of corporations through officers or directors, or common ownership of a substantial amount, though less than a majority of their stock, gives such indication of unified control as to call for close scrutiny of a contract between them whenever the reasonableness of its terms is the subject of inquiry."

In its recent decision in *Rochester Telephone Corporation* v. *United States* (307 U. S. 125, 59 S. Ct. 754 (1939)), the Supreme Court swept aside all rigid or artificial tests of control. In answer to the contention that actual control could not be exerted through the ownership of only one-third of the common stock, the Supreme Court said (pp. 145–146):

"The record amply justified the Communications Commission in making such findings. Investing the Commission with the duty of ascertaining 'control' of

[21] Cf. *New York Central Securities Corp.* v. *United States* (287 U. S. 12); *Federal Radio Commission* v. *Nelson Bros. Co.* (289 U. S. 266).

one company by another, Congress did not imply artificial tests of control. This is an issue of fact to be determined by the special circumstances of each case. So long as there is warrant in the record for the judgment of the expert body it must stand. The suggestion that the refusal to regard the New York ownership of only one-third of the common stock of the Rochester as conclusive of the former's lack of control of the latter should invalidate the Commission's findings, disregards actualities in such intercorporate relations."

The Court went on to discuss further the minority ownership of the Rochester Telephone Corporation by the New York Telephone Co. After discussing the history of the relationship between these companies, the financial transactions between them, the operation of a voting trust, and the existence of certain charter restrictions, the Supreme Court said (p. 145):

"Putting all these factors in the context of the circumstances under which the Rochester came into being, the manner in which it was financed, the operation of the voting trust, and the stake of the New York in the Rochester, the Commission, after full hearing and due consideration, concluded that 'the New York Co., through stock ownership, is the dominant financial factor in the respondent company and also that this, taken together with their contractual arrangements and other pertinent facts and circumstances appearing in the record, unquestionably gives the New York Co. power to control the functions of the Rochester Telephone Corporation.' " [22]

Considering the matter as though no voting trust had been created and as though Byllesby continued to hold the 330,000 shares of common stock, series B, of Standard Power directly, we should be impelled to hold that Byllesby, both "alone" and "pursuant to an agreement or understanding" with the other investment bankers exercised "a controlling influence" over the management and policies of Standard Power and Standard Gas. Among the facts in the record which would require this conclusion are: (1) The past relationships between Byllesby and the Standard companies have resulted in a personnel and tradition which make the Standard companies responsive to Byllesby's desires; (2) Byllesby alone can elect one less than a majority of the directors of Standard Power; (3) Byllesby together with the other investment bankers can elect all of the directors of Standard Power; (4) five out of the nine present directors of Standard Gas, elected since the reorganization of 1938, represent Byllesby and the other bankers; (5) Byllesby and the bankers have been able to allocate as they have pleased the underwriting of the Standard system companies' securities among themselves and other bankers of their selection.[23]

We turn next to a consideration of whether the creation of the voting trust has destroyed the controlling influence otherwise existing. We have already stated that a mere change in legal form of control is insufficient; the actual facts are determinative. In *International Paper and Power Company* (2 S. E. C. 274 (1937)), after referring to the general standard laid down in section 2 (a) (7), we said at pages 277–278:

"But what the act points to both explicitly and implicitly, is that these questions of 'ownership,' 'control,' 'holding with power to vote,' are to be determined by reference to *realities and not by reference to legal abstractions*. In other words, whether the voting trust device—a device adverted to in the hearings before the Congress—was effective to sterilize the ownership of stock of New England Power Association must be determined by this Commission on the basis of examination not of legal formalisms but of whether actual control does or does not exist." [24] [Italics supplied.]

We are doubtful that a voting trust (except possibly a voting trust established solely for the purpose of liquidation) can ever operate effectively to insulate the

[22] The question in the *Rochester Telephone case* involved the meaning of "control" as used in sec. 2 (b) of the Federal Communications Act of 1934. This statute subjected to the jurisdiction of the Communications Commission any carrier directly or indirectly controlling or controlled by any other carrier engaged in interstate or foreign communication. It will be observed that the statutory language is very similar to that used in sec. 2 (a) (7) of the Holding Company Act.

Compare also *Electric Bond and Share Company* v. *Securities and Exchange Commission*, 303 U. S. 419 (1938).

[23] It is clear that controlling influence over one phase of a company's business, such as over underwriting policies, is "controlling influence" within the meaning of the act. The statutory language is "a controlling influence over the management or policies"; the word "or" shows that a controlling influence over the details of management is not required so long as a controlling influence is exerted over policies. Obviously any other construction would enable a holding company to evade the provisions of the act merely by limiting its supervision to underwriting and such other particular matters as were profitable to it.

[24] Our decision in the *International Paper and Power Company case* was reversed on jurisdictional grounds by the Circuit Court of Appeals for the First Circuit in *Lawless* v. *Securities and Exchange Commission* (— F. (2d) —— (1939)). The court's opinion did not discuss or pass upon the question of control or the legality of the use of voting trusts.

control which ownership of a block of stock carries. But apart from that fact, it is clear that a voting trust in which the voting trustees are not completely independent of the depositors does not operate to insulate control. Serious question exists as to whether the voting trust agreement in this case permits the voting trustees to act independently of the wishes of Byllesby. As we have previously pointed out, the voting trust agreement contains a provision which enables Byllesby to prevent the deposit of common stock, series B, held by other persons. To date no other stockholders have deposited under the voting trust agreement. Byllesby is, therefore, the sole beneficiary of the trust, and the trustees are bound to act for Byllesby's benefit. Moreover, Byllesby and the voting trustees may terminate the agreement by mutual consent at any time.[25] In fact it was admitted that one of the principal reasons for the provisions preventing deposits without Byllesby's consent was to make possible dissolution of the trust should circumstances make it desirable.

The original voting trustees, Lynch, Morrison, and Cummins, who held office throughout the period during which most of the hearings were held before the trial examiner, were not in fact sufficiently independent to insulate Byllesby's control over Standard Gas. They had long been intimately connected with Byllesby and with the Standard System under Byllesby's domination. Moreover, they continued to hold securities in the Byllesby Corporation. In view of these circumstances, it could have been expected that these trustees would, if possible, insure Byllesby's participation in Standard underwriting.[26] The record of experience from November 1936 to September 1938, during which these voting trustees were in office, bears out their expectation. Byllesby secured underwritings during this period on the same basis as before. In fact, except for the removal of interlocking directors and officers, there was no change in management or business relationships. Byllesby continued to maintain its offices on the same floor as those of Standard Gas. Byllesby and Standard Gas used the same telephone number. Offices of Standard Gas and of Standard Power continued throughout most of this period to use Byllesby's private wire between New York and Chicago. Many of the officers and directors of the Standard System who continued to operate the system were substantial stockholders of Byllesby.

Thus it is clear that in spite of the creation of the voting trust, Byllesby continued to retain a controlling influence over the Standard System Companies. Nothing in the record indicates any change in this situation either prior to or subsequent to September 8, 1938, the date of appointment of the new voting trustees.

Applicants urge that, even assuming the exercise of a "controlling influence" by Byllesby over the Standard System Companies, that influence was not such "as to make it necessary or appropriate in the public interest or for the protection of investors or consumers" that the applicants be held holding companies under the act.

To give effect to the standards of "the public interest," "the protection of investors," and "the protection of consumers," we must look to the evils which the act is designed to eliminate. Thus, section 1 (c) provides:

"* * * it is hereby declared to be the policy of this title, in accordance with which policy all the provisions of this title shall be interpreted, to meet the problems and eliminate the evils as enumerated in this section, * * *."

Among the evils enumerated by the Congress which the act was intended to eliminate were those resulting "from an absence of arms-length bargaining" and "from restraint of free and independent competition" (sec. 1 (b) (2)). One of the manifestations of these abuses was the monopoly exercised by investment bankers over security issues of holding companies and their subsidiaries. Excessive charges by investment bankers in control of utility companies for underwriting the latter's securities were not uncommon. Further, such bankers, desirous of obtaining underwriting fees, were sometimes guilty of causing security issues to be floated even though they were ill adapted to the security structure of the issuer

[25] It is well settled that all parties in interest may terminate a trust. *Helvering* v. *Helmholz* (296 U. S. 93, 97 (1935)); *Western Battery and Supply Co.* v. *Hazlett Storage Battery Co.* (61 F. (2d) 220, 231 (C. C. A. 8th. 1932), cert. den., 288 U. S. 608); *Rowley* v. *American Trust Co.* (144 Va. 375, 132 S. E. 347, 45 A. L. R. 738 (1926)); *O'Brien* v. *Holden* (104 Vt. 338, 160 Atl. 192 (1932)); *Fredericks* v. *Near* (268 Mich. 627, 245 N. W. 537, 538 (1933)); *Riedlin's Guardian* v. *Cobb* (222 Ky. 654, 1 S. W. (2d) 1071 (1928)). See also annotations in 38 A. L. R. 941, 965, and 45 A. L. R. 743. Several of these authorities indicate that the sole beneficiary may terminate a trust even without the consent of the trustees.

[26] The underwriting of securities of Standard system companies bulks large in Byllesby's total business; from 1930 to 1937, its underwriting of securities of Standard system companies comprised 46.3 percent of all of its underwriting business.

and even though they bore no reasonable relation to the economical and efficient operation of the issuer's business.[27] As pointed out in the report of the National Power Policy Committee, transmitted to Congress by the President in March 1935 (H. Rept., 74th Cong., 1st sess., Doc. 137, p. 6):

"Fundamentally the holding-company problem always has been, and still is, as much a problem of regulating investment bankers as a problem of regulating the power industry."

Arm's-length bargaining concerning security issues by companies in the Standard System has been conspicuously absent ever since the organization of Standard Gas in 1910. From 1910 to 1929 Byllesby completely dominated all Standard financing. Since 1929 Byllesby has shared its monopoly with a few investment bankers who have held Standard Power common stock. At no time has any attempt been made by the Standard System Companies to secure financing on a more favorable basis from investment bankers other than those in this group.

This absence of arm's-length bargaining and the many other manifestations of investment banker control throughout the period of September 1938 would have made it impossible to find that Byllesby did not exercise "either alone or pursuant to an arrangement or understanding with one or more other persons such a controlling influence over the management or policies" of Standard Power and Standard Gas "as to make it necessary or appropriate in the public interest or for the protection of investors or consumers" that Byllesby be declared a holding company under the act. Accordingly, had there been no change in the personnel of the voting trust, we should be compelled to deny the applications under section 2 (a) (7).

We consider next the effect of the appointment of the new trustees. At the time the case was argued before us, these trustees had been in office only a few weeks. As pointed out above, at the reopened hearing they testified that they had performed no duties as trustees and had done no more than consider in a general way the nature of their duties as voting trustees.

Applicants urge that the new trustees are completely independent of Byllesby. The evidence merely shows that these trustees had not been actively identified with Byllesby, although Doriot's past connections might cast some doubt upon his independence.[28] In our opinion, the facts contained in the record are not sufficient to permit us to find that the new trustees are completely independent of Byllesby, the creator of the trust.

Under the terms of the act we can, of course, pass upon an application only upon the basis of the facts contained in the record presented to us. On the present record we cannot find that the facts bring the applicants within the exemption provisions contained in section 2 (a) (7), and the applications for orders declaring that applicants are not holding companies under that section must, therefore, be denied.[29]

As alternative relief, applicants have applied for orders exempting them from the provisions of the act, under sections 3 (a) (3) and 3 (a) (5).

Section 3 (a) (3) provides:

"The Commission, by rules and regulations upon its own motion, or by order upon application, shall exempt any holding company and every subsidiary company thereof as such, from any provision or provisions of this title, unless and except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers, if— * * *.

"(3) Such holding company is only incidentally a holding company, being primarily engaged or interested in one or more businesses other than the business of a public-utility company and (A) not deriving, directly or indirectly, any material part of its income from any one or more subsidiary companies, the principal business of which is that of a public-utility company, or (B) deriving a material part of its income from any one or more such subsidiary companies, if substantially all the outstanding securities of such companies are owned, directly or indirectly, by such holding company; * * *."

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[27] The policy of Congress with respect to relationships between holding companies and investment bankers is illustrated by the provisions of sec. 17 (c). That section, among other things, forbids any executive officer, director, partner, appointee, or representative of an investment banker to serve (subsequent to Aug. 26, 1936) as a director or officer of any registered holding company or subsidiary thereof except in cases permitted by rules and regulations of this Commission. The application of that section to the present case is not before us.

[28] Doriot had previously been elected a director of Standard Gas. Prior to March 1937, he had been connected with Ladenburg, Thalmann & Co. Doriot also has had business connections with the Schroder interests. The trustees testified that they expected to receive compensation from Byllesby.

[29] Since applicants are applying for an exemption, it would appear that the burden rests upon them to establish facts bringing them within the exemption provisions. See *Securities and Exchange Commission* v. *Sunbeam Gold Mines Co.*, 95 F. (2d) 699 (C. C. A. 9th, 1938), wherein it was held that the burden was on a security issuer to prove facts bringing it within an exemption provision of the Securities Act of 1933. See also *Houston Natural Gas Corporation*, 3 S. E. C. — (1938), Holding Company Act Release No. 1184.

Section 3 (a) (5) authorizes us to grant an exemption under the same conditions if—

"* * * such holding company is not, and derives no material part of its income, directly or indirectly, from any one or more subsidiary companies which are, a company or companies the principal business of which within the United States is that of a public-utility company. * * *."

Byllesby contends that if it be deemed a holding company within the meaning of the act, it is only incidentally so, its primary business being investment banking. To this it adds the further contention, upon the validity of which the availability of an exemption under those sections depends, that it does not derive, directly or indirectly, any material part of its income from a subsidiary public utility. More specifically, the latter contention is that when Byllesby participates in an underwriting, it is merely buying a commodity—securities. At the time of purchase from the issuer, that transaction is complete, and no profit or loss is then realized. It is only after the securities are marketed that profit or loss occurs. Profits, it is claimed, are derived from purchasers, not from the issuer of the securities. Accordingly, so the argument runs, while the underwriting of securities of Standard System Companies admittedly is a principal source of Byllesby's income, that income is derived from the purchasers of the securities rather than from such companies, and the terms of sections 3 (a) (3) and 3 (a) (5) are met.

This argument ignores the realities of an underwriting transaction. It is true that the underwriter must sell securities before it can derive a profit. But that profit, in a real sense, represents compensation in the form of an underwriting spread for the performance of services for the issuer. There can be no doubt that in the so-called "best effort underwriting contract," where the underwriter agrees to use its best efforts to sell the securities of the issuer, and where it receives a designated fee on the basis of the securities it sells, the underwriter is deriving its compensation from the issuer. In such a case, the underwriter occupies a position analogous to that of a salesman of securities, and its remuneration comes from the issuer. So far as the source of the underwriter's income is concerned, the situation does not appear to us to be different where the underwriter enters into a "firm commitment" with the issuer, either purchasing an entire issue outright or agreeing to take up the unsold portion of an issue, at a designated price. Congress could not have intended that the availability of an exemption under sections 3 (a) (3) and 3 (a) (5) should turn upon the form which underwriting contracts take. On the facts before us, which show that from 1930 to 1937, the underwriting of securities of Standard System Companies comprised 46.3 percent of all of Byllesby's underwriting business, we hold that Byllesby derives a material part of its income from Standard Gas subsidiaries.

Conclusion.—On the basis of the facts presented by the record, we find it necessary to deny the applications, both with respect to section 2 (a) (7) and sections 3 (a) (3) and 3 (a) (5).

In order that applicants may have an opportunity to adjust their business to the situation, we shall, if requested by applicants, defer the issuance of a final order for a period of 60 days during which applicants may make such adjustments as they deem necessary, and shall treat the applications as pending before us until such final order is entered.

By the Commission.

[SEAL] FRANCIS P. BRASSOR,
Secretary.

JANUARY 15, 1940.

Senator HUGHES. I want to ask a question off the record.

(A discussion was had which, at the direction of Senator Hughes, was not recorded.)

Senator WAGNER (chairman of the subcommittee). We will adjourn now until 10:30 tomorrow morning, and Mr. Schenker will be the first witness.

(Thereupon at 12:30 p. m. an adjournment was had until tomorrow, Friday, April 5, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

FRIDAY, APRIL 5, 1940

United States Senate,
Subcommittee on Securities and Exchange of the
Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes and Frazier.

Senator Wagner. I think the subcommittee had better proceed with its hearing. I have proxies of members to account for a quorum, and no doubt some of them will come in a little later on.

Mr. Schenker, were you to testify first this morning? I see that Mr. Mathews is here.

Mr. Schenker. Mr. Mathews will go on directly after I close, and I hope not to be long with this statement.

Senator Wagner. Then you may proceed.

STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, SECURITIES AND EXCHANGE COMMISSION, INVESTMENT TRUST STUDY, WASHINGTON, D. C.—Resumed

Mr. Schenker. Yesterday Mr. Stern described the rise in the United Founders Corporation, and during the course of his discussion he showed that Founders raised $500,000,000 of the public's money.

In 1933 the group that was controlling Founders sold their controlling block of stock to another investment trust—but I will discuss that a little bit more in detail shortly. At the time that this controlling block of stock was sold the assets of United Founders Corporation were $47,000,000, so that from $500,000,000 it was down to $47,000,000 in 1933.

Now, one would assume that after a person managing half a billion dollars of other people's money, lost all of it except $47,000,000, he would take his hat and coat and go home. But that was not the fact. After the assets of that company dropped from half a billion to $47,000,000, those insiders took their class A stock, which I will describe in a moment, and sold it for $1,200,000 to another group, controlling another investment trust, and turned over the $47,000,000 of other people's money to this new group.

The fact of the matter is that at the time of this transfer of $47,000,000 of other people's money to a new management group, the stock of the insiders was worth only $45,000.

Now, let me just describe briefly what this class A stock was. You will remember that Mr. Stern described how, first, they organized one company and sold that stock, they organized another company and sold that stock, and organized still a third company and sold that stock, I mean to the public.

Now, the feeling one gets from this entire picture is that these companies were being created, not because those people had any faith in the economic soundness of these companies but organized these companies because the public was prepared to buy their stock. So you had this picture of company after company after company being formed merely because the public was prepared to buy stock and they could thereby increase their funds.

After they organized one, two, three, four, five, six and seven companies, and had interests in other companies, they wanted to solidify their control of this $500,000,000. What did they do? They organized United Founders Corporation, which is the top holding company shown on this chart, and this is the capitalization of that company: There are two classes of common stock, one being A stock, and the other being common stock. The class A stock, which is the voting stock, had this voting power: that regardless of the number of shares of other common stock outstanding the A stock had a vote at least equal to one-third of all the outstanding stock.

Now, ultimately there were 6,000,000 shares of common stock held by the public, and the A stock, which was issued to the insiders, then had a vote of 3,000,000 shares; because if you take the six million and the three million it gives you nine million votes, and their stock always had one-third of the voting power. So you had the situation where they raised half a billion dollars of the public's money—and through their management as described by Mr. Stern yesterday, you saw what happened in the case of United States Electric Power Corporation, and what happened in the case of General Investment Corporation, where the assets of General Investment went from $78,000,000 down to $8,000,000, and the assets of United States Electric Power Corporation went down from $130,000,000 to $132.

Well, those people still had the power to vote the A stock, and to control the A stock, so they sold it for $1,200,000, and thereby turned other people's money over to a new group. And we will see what the new group did with the balance of the funds which they had.

Now, we say and recommend, and the bill incorporates that recommendation, that this recurrent promotion of companies, which seems to be generated not through any impulse that there is any economic significance to that type of promotion but merely for the purpose of generating merchandise that they can sell to the public, we say that that is unhealthy economically and undesirable, and the bill says: Hereafter you cannot at your whim organize an investment trust every time you think you can sell stock to the public.

And what other situation do you have here? You have these companies, one piled on top of another, and then superimposed upon that still another company.

Now, I do not know much about holding companies, but it seems to me in the public utility situation at least a holding company performs some economic function. You have an operating company here, there and elsewhere, and you superimpose upon them the holding company which will keep those three plants together, and

possibly raise funds from the public which can be supplied to the underlying companies.

But there is nothing like that in the case of an investment trust. There is no economic purpose served by piling one company upon another. It is just a device to sell securities, to raise more money.

When we come to discuss the section of the bill which deals with pyramiding of these companies, one investment trust owning another, we will give you not one but innumerable examples of where this has been done. In other words, pyramiding is not rare but exists at the present time.

The Commission says they feel the time has arrived, and it must not be forgotten that the bill at the present time does not try to disturb the pyramided situations as they exist; that such a situation as I have described is unhealthy economically and is undesirable. We say: A stockholder can never tell what the value of his stock is, but we say: You exist and we will maintain the status quo, but as far as the future is concerned you ought not to be permitted to pile one investment trust upon another.

You cannot get an idea of the complicated structure here until you learn that each one of these underlying companies had two, three, and four different kinds of stock. How to figure out the value of the stock is beyond us.

We feel that as far as the future is concerned nobody should be permitted to organize investment trusts just because he can sell their securities. We feel he should not be permitted to pyramid them, one upon another, so that he can get concentration of control of great wealth through the device of management stock.

Senator WAGNER. Can you offhand tell us what time intervened between the organization of these companies, one after the other in the group?

Mr. SCHENKER. The fact of the matter is, as I recall it, that the first company was organized in 1922. The United Founders Corporation, the one shown at the top of the chart, was organized in 1929. Do not be shocked by this, but we will give you cases where one group organized six investment trusts in 1 year and we will show why that sort of thing should not be permitted to continue.

One cannot organize six banks, one after another; one cannot organize six insurance companies, one after another; one cannot organize six building and loan associations, one after another; one cannot organize six mortgage associations, one after another, unless he gets permission from some governmental agency that there is nothing undesirable about these recurrent promotions.

Senator WAGNER. Didn't the shareholders sense the unfortunate situation in this other case?

Mr. SCHENKER. You might have got the impression yesterday from Mr. Stern that this was ancient history, and that this only took place back in 1928 and 1929. The fact of the matter is that the last little brush took place in the middle of 1939, after you had the 1933 act, and after you had the 1934 act, and after you had the 1935 act, because in November of 1935 what did they do? They sold this United Founders Corporation, which at the time only had $47,000 to The Equity Corporation.

Now, when I say The Equity Corporation you may think this is a simple little company, with one class of stock; but it was a pyramid of these investment trusts managing other people's money.

If you will take a look at this chart you will see the setup. Equity Corporation was even worse than United Founders Corporation. This chart shows Equity Corporation at the time Founders was sold to Equity.

Now, I would like to introduce, if I may, a picture of the Equity Corporation as of about the time the Equity Corporation got control of United Founders Corporation.

Senator WAGNER. Have you more than one copy of that chart.

Mr. SCHENKER. We have plenty of copies.

Senator WAGNER (chairman of the subcommittee). This chart will be made a part of the record at this point.

(The chart entitled "Equity Corporation" is made a part of the record.)

Senator WAGNER (chairman of the subcommittee). You may proceed with your statement.

Mr. SCHENKER. Now, at the time control of United Founders Corporation was transferred to Equity Corporation, it owned the Yosemite Holding Corporation, which in turn owned Chain and General Equities, Inc., which in turn owned Interstate Equities Corporation, and through these investment trusts they owned General American Securities Corporation, Majestic Fire Insurance Co., American Colony Insurance, Colonial States Fire Insurance Co., and Germanic Fire Insurance Co. Owning all these insurance companies, what did they do? They reinsured the risks and really made investment trusts out of these four insurance companies so that there was this complicated situation. I will introduce a chart in a few moments showing what was above Equity Corporation, but there you have this tremendously complex situation.

Now, what happened? They sold the A stock to an investment company subsidiary. The Equity Corporation, and this A stock had a vote equal to one-third of the total voting power outstanding.

Then the new group started out, with that control, messing round with the capital structures of these underlying companies, all with a view to collapsing the structure and making one company out of it. Ultimately, in 1935 this entire structure was collapsed and the name of the Founders Companies was changed, and it became known as the American General Corporation.

I do not want to discuss in detail at the present time what happened to the stockholders in the process of recapitalizing these corporations and in the process of the exchange phase. That is dealt with in two reports, one by the Commission and one by the protective committee. These reports have been transmitted to the Congress.

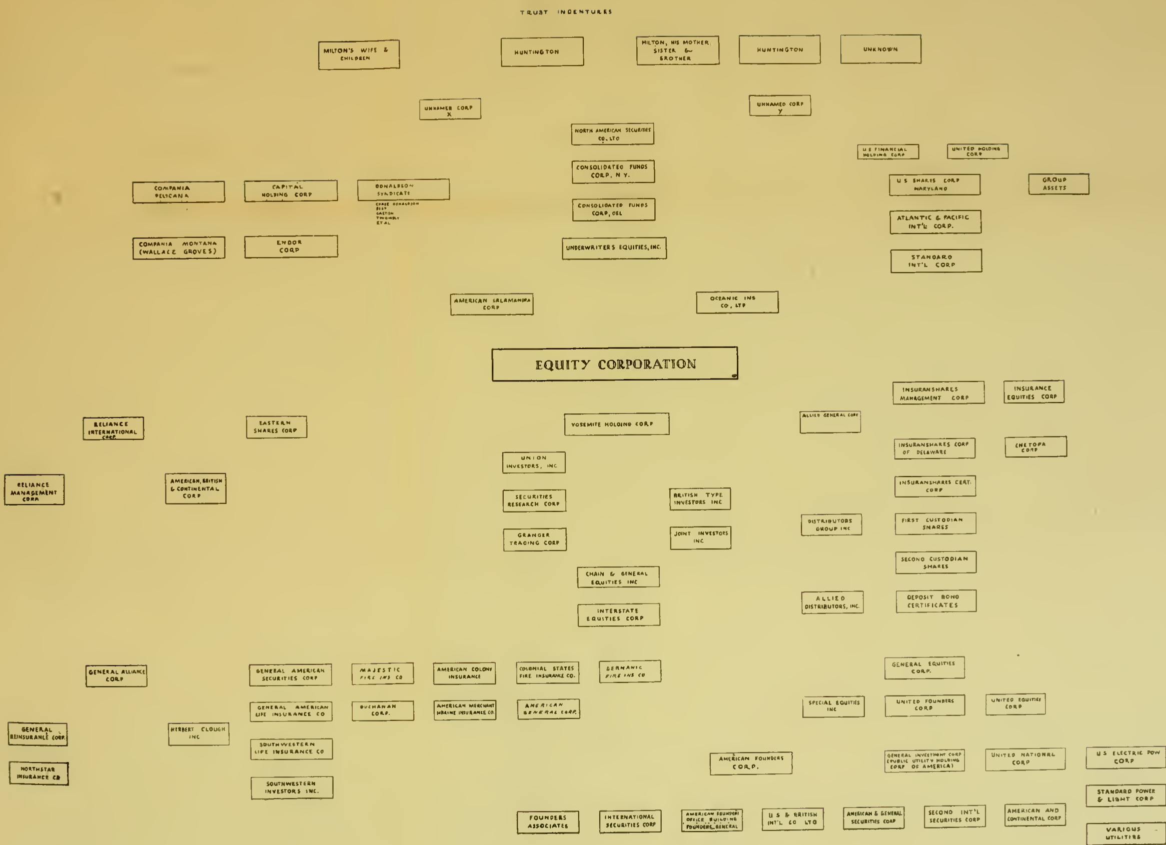
Let me take a minute and tell you what happened to General Investment Corporation, which was a part of the picture of Founders. Mr. Stern told you how this company flopped from $78,000,000 to $7,000,000 or $8,000,000.

Senator WAGNER. I did not quite catch that latter figure. Did you say it dropped from $78,000,000 to $70,000,000?

Mr. SCHENKER. No. It went down from $78,000,000 to $7,000,000 or $8,000,000.

Mr. WAGNER. Oh, I thought the latter figure was $70,000,000.

Mr. SCHENKER. No. And that loss was sustained how? Senator Townsend asked whether that loss was not entirely attributable to that fact that there was a stock-market crash. Nobody denies that



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that crash contributed to the drop, but that crash did not contribute in toto to the experience of United States Electric Light & Power, and certainly did not have as much to do with it as the transaction of the insiders in the case of General Investment Corporation, when they sold them the South American subway, and Central Public Service when they sold them German and French credits.

Here you have the stockholders taking a beating to the tune of \$70,000,000. Now, what happened? In 1933 another individual is put in charge of the company. His name is George Devendorf. Well, the first thing they do is, George Devendorf, as I recall it, made an investment of about \$100 in preferred stock. By the time he got through he had the corporation, by buying the preferred stock of the company, and reselling it to the company and he realized about \$1,000,000. About \$2,000,000 of the company's funds were used to buy its stock. The stockholders dropped \$70,000,000 in that picture. There is \$7,000,000 left. And where is that? It is in the subway in Buenos Aires. That is the only asset left in that picture, the only straw to which the stockholders can look to get a part of their money back in any eventuality.

Now, let me tell you what happened to the subway.

Senator WAGNER. Before you go to that let me ask you a question: You said \$100,000,000 became \$1,000,000 to one individual. Tell us about that.

Mr. SCHENKER. Well, he started out with—and our report covers it—he started with \$100 and went ahead trading in the preferred stock, building it up until he got a big position which he sold at a profit of \$1,000,000. This is not unusual and we can give you innumerable cases to show it; and I do not want you to think for one moment that these instances we give you are isolated; and I am sincere in this, that I do not intend to impugn this industry, for I think there are people in it who have the highest sense of fiduciary duty. I believe there are people in here who are trying to do the job right. However, our study and analysis over a periof of 4 years shows that the very nature of this institution, which is like a bank, where you are dealing with cash, presents a definite situation: You cannot back a truck in at some place and go away with a steel plant, but you can go to a safety-deposit box and take \$1,000,000 therefrom. That is the reason this is a different type of institution. It is an equity savings bank, and ought to be subject to regulation and supervision such as is comparable to the regulation and supervision of similar types of institutions. As I say, I am not intending to impugn the institution. I have been in pretty close relationship with many people engaged in it and I know a large number of them. We have talked with them, have studied the situation with them, and I would be the last person in the world to say there is no ability in the industry, no high-grade men in the industry.

But I do say this in all seriousness: No matter how good a single individual investment company may do its job the unfortunate thing is that all you need is one bad actor and the work the others have done is wiped out; and that has been the experience during even the course of our own investigation. If you take one example, Continental Securities, the experience offsets all the good work ourselves and the industry are doing. We did not intend to mess with people who were trying to do a good job, those who had a real interest in the industry

of investment, but look to special situations like Continental Securities. And that is all that this bill contemplates.

It may be that our language is not precisely accurate. It may be we forgot to put a comma at one place and a semicolon at another place; but after we discuss this bill you will be convinced I think that this bill merely intends to set forth certain fundamental basic principles which good businessmen are obeying, to the end that nobody can enter this type of institution unless he is prepared to observe the proper fiduciary relations.

Now, about that subway: In August of 1936, United Founders Corporation sold its controlling block of stock of General Investment Corporation to an individual by the name of Ernest B. Warriner. I do not want to confuse the record at the present time but during the course of the hearings on the bill we will tell you who Mr. Warriner is. Mr. Warriner bought this block of stock for $189,000, and as is not unusual—and, Senators, you will see that the same pattern which was applicable in 1928 and 1932 was applicable in 1937. I am sorry as to the date. Well, they sold control to Warriner in August of 1936—did I say that before? Anyhow, I am not talking ancient history but am talking how this thing took place recently. It was during the very course of our investigation. We started our investigation in December of 1935. We had our field study for about 6 months and announced the first examination for July of 1936, and the first company we studied was a company in which Mr. Warriner, and a certain Mr. Groves, whom I will show you is tied up in this picture—and the first companies we had a public examination of were companies in which Warriner and Groves had been interested and had depleted. We will tell you later on how they did that.

At any rate, in August of 1936, Mr. Warriner buys this controlling block of stock of General Investment Corporation, and he needs $189,000 to do it, and he has not got it. He borrows $139,000 at some place, and $50,000 from somebody else, and buys the controlling stock of International Equities. The block of stock that he bought—no; I am sorry, but International Equities he bought from somebody else and not from Founders. Well, he has control of International Equities, and of course the block of stock he has is not majority voting control.

What does he do? He sits down and makes a contract with an individual by the name of Kolb, that he will buy a big block of stock from him personally, and Mr. Kolb does not make any payment on the stock but says, "I will pay it to you later on." Immediately Mr. Kolb's group resigns from the board of directors and Mr. Warriner's board of directors move in. As soon as they move in they adopt a resolution that International Equities Corporation will take over Mr. Warriner's personal commitment to buy the block of stock, and the corporation buys in the stock.

What was the result of that? By buying that stock in they reduced the outstanding stock so that Mr. Warriner's original block, which was only 30 percent of the voting power, now becomes over 50 percent because they had the corporation buying a big block of outstanding stock and thereby reduced the number of shares outstanding.

So you have Mr. Warriner in control of International Equities with the payment of $189,000. Mr. Groves and Mr. Warriner testified for us in July of 1936. And right here let me tell you, Senators, there

were times, or there was a time during the investigation when Mr. Grove was asking for a recess, and I assumed he was going out to get a drink of water. However, in retrospect I think he was making telephone calls to close the very deals we are talking about. [Laughter.]

The next thing we see, in August of 1936, United Founders sells control of General Investment Corporation to International Equities Corporation, General Investment Corporation being a company which only had the subway in South America.

During all this time and particularly around May of 1936 an individual by the name of Billings, the manager of the subway, had been carrying on negotiations and had received an offer of about $7,500,000 for the subway. He sent wires up there—and I have a copy of that offer—and I might say that the purchase of this subway was being financed by the Instituto, which corresponds to our Reconstruction Finance Corporation. They were going to finance the purchase of the subway from the investment trust.

Senator WAGNER. What country is that?

Mr. SCHENKER. That is at Buenos Aires, a pretty long way from home, it is true, but that is all right. And, Senators, the practical thing is that this bill says if you want to invest in a Buenos Aires subway, that is perfectly all right under this bill, but you have to tell your stockholders before you sell stock that that is the type of business you are going to invest in, or if you are in a diversified company which is buying various types of stocks, and you make up your mind you cannot make money buying stocks on the stock exchange and want to buy a subway, that is all right, but in order to do so you must tell your stockholders you are going to change the nature of your business, and get their approval for that.

Suddenly there appears as one of the negotiators on the scene an individual by the name of Philip De Ronde. Of course Billings was carrying on the negotiations in Buenos Aires.

Now, at the present moment I am not talking about looters. You may get the impression from my mention of Continental Securities that there were a lot of irresponsible people, but I am talking about people connected with investment trusts. For instance, there is the Phoenix Securities Corporation, involved in this picture. That corporation is not a little penny institution. Today it controls United Cigar Stores, Lofts, Pepsi-Cola, Certainteed, Celotex, New England Bus Co., and a sugarcane company. But that is a different story. We will give you here how Philip De Ronde was associated with Mr. Groves and Phoenix Securities.

Well, suddenly he is sent down to South America to close that deal. They closed the subway deal and got a price of $7,500,000, $5,750,000 in cash and $1,750,000 the investment trust had to keep as participation, and they sent $5,750,000 up to New York.

I have told you what happened to the subway. Now let me tell you what happened to the $5,750,000. Mr. De Ronde suddenly tells Mr. Warriner that he has to pay $150,000 to somebody down in South America, and that he needs it in cash. Warriner says: What is your commission for selling the subway? He said $250,000.

Doubtless you will assume that if a person is entitled to a quarter of a million dollars as a fee, they would sit down and write a check for

it and pay him. Well, they sat down and wrote a check to Philip De Ronde, Ltd., and then tore that up. Then they wrote another check and tore that up. Then they wrote another check and tore that up. They drew five or six checks, and finally sent a secretary to the bank with instructions: You make sure that you get this money in $1,000 bills. Do not come back here with anything else.

When I examined Mr. De Ronde I said I had heard of people insisting on getting $5 and $10 bills, but that was usually connected with kidnaping activities. I told him I had never heard of anybody insisting on getting $1,000 bills, and here he was with $250,000 in cash walking around for a couple of weeks. But Mr. De Ronde got that money and turned it over to the Philip De Ronde Co. When he came on the stand he was asked "Who is that?" and he replied "I can't tell you that." Then there was the question "You cannot tell me. Are you a stockholder of that company?" The response was "No." Then the further question "Are you an officer?" and the response "No." Then there was the question "Well, to whom did you turn it over?" and the response "I am sorry but I turned it over to the corporation." Then the question "Who is the corporation except the officers, directors and stockholders?" and the response "I cannot tell you that." Whereupon Judge Healy says "I will not take such answers to the questions." and he replied "Can I call up a lawyer?" and he was told "Yes". Then Mr. De Ronde stepped off the stand and has never been heard of since, went down to South America.

The judge says his face has been red ever since.

There goes $400,000 of the $5,750,000. Mr. Wallace Groves' investment trust, that is, Phoenix Securities Corporation, bought stock of Certainteed Products Corporation for $3,000,000. This stock had been in arrearages of dividends for years. The first thing we know more than a million dollars worth of the Certainteed stock was sold by Phoenix Securities Corporation to the General Investment Corporation. There goes $1,400,000 more of General Investment Corporation's cash. Phoenix Securities Corporation also had acquired 40 percent of the common stock of Standard Investing Corporation, another investment trust. This stock had no asset value and was important only for control purposes. However, the existing management of Standard Investing Corporation had refused to turn over control of Standard Investing Corporation to Phoenix Securities Corporation and had been victorious in a proxy fight for the management of Standard Investing Corporation. The management had won this proxy fight although it owned only 5 percent of the common stock of Standard Investing Corporation. Incidentally, this proxy fight illustrates the importance of control of the proxy machinery to managements, because it enables them to keep in power even if they have insignificant amounts of stock of the investment companies they dominate. Having failed to get control of Standard Investing Corporation, the Groves-controlled Phoenix Securities Corporation sold the Standard Investing Corporation stock to General Investment Corporation for $650,000. That reduced the cash left in General Investment Corporation to about $3,000,000.

Then Mr. Devendorf, who had this big block of preferred stock—after learning of the transfer to Warriner decided he would like to have a little representation on the board of directors—after all, they were big preferred stockholders—but Mr. Warriner said, "No; no represen-

tation." So he said he was going to get out of this picture. Whereupon he goes to Mr. Warriner and says, "Will the G. I. C. buy my preferred stock at $87.50 a share?" "No; we can't afford the money. It is the only cash we have got. However, I will take you to Mr. Groves. He will be interested in buying your preferred stock."

Whereupon, he approached Mr. Groves and made a deal with Mr. Groves that he would sell his preferred stock at $87.50 a share. Mr. Groves said to him, "I will make the same offer to every other stockholder."

This took place about 2 years ago.

Mr. Groves said to the preferred stockholders, "If you will deposit your preferred stock at the Royal Bank of Canada on January 21, 1937, I will pay you $87.50 a share on January 25, 1937."

Somehow or other, although Mr. Warriner was not interested in repurchasing the preferred stock with the corporation's money, we find that approximately $2,500,000 of the cash of the General Investment Corporation, is suddenly deposited up in the Royal Bank of Canada, and before that time it never had a cent of the company on deposit. More money was being moved up there by Mr. Warriner of the G. I. C.

On January 22 they know how much stock has been deposited by the preferred-stock holders and they know how much money they need to buy it, and Mr. Groves and Mr. Warriner sat down and wrote out a contract that "General Investment Corporation will pay you $102.50 for every share of preferred stock deposited in the Royal Bank of Canada"—and that amounted to about two and a half million dollars.

So, on January 22 Mr. Groves takes all the preferred stock which was deposited by the preferred stock holders in the Royal Bank of Canada, turns it over to the General Investment Corporation on January 23. On January 23 the General Investment Corporation, out of the moneys accumulated in Canadian bank pays $102.50 to Mr. Groves, and he takes $87.50 and pays it to the stockholders on January 25 and keeps the difference between the $87.50 and the $102.50, and made a profit of $300,000 without even investing a nickel.

Then General Investment Corporation had a little money left, so they went ahead and bought another investment trust, known as Utility Equities.

About this time we started asking a few questions, and Mr. Warriner suddenly got a nervous stomach and started taking pills up in Canada, and he has been taking them up there ever since and has never come back.

You will find that every nickel of the six and one-half million dollars was disbursed in the way I have shown you.

Suddenly the Founders group institutes a lawsuit against the International Equities. By this time Warriner had sold International Equities to somebody else and made $2,000,000 on his $189,000 investment in that situation. He sold it to a group controlled by the Henderson brothers up in Boston. The United Founders instituted suit against the International Equities for a rescission of the contract, saying they did not know that Mr. Groves was really behind Mr. Warriner; that he was the one that really bought the company, and that they would not have done it, and so forth. But that is another story that I will tell you. G. I. C. is today back in the Founders group. And who is

one of the leading figures in the General Investment Corporation today? G. I. C. was sold back to United Founders. It today is known as American General Corporation. So that it made a complete circle, from Founders to Warriner to Henderson back to Founders. And Mr. Seagrave, the one who was with the United Founders Corporation from its very inception, was one of the individuals who had the A stock and is still chairman of the board of directors of the United Founders; so that G. I. C. is back partially under the management of Seagrave.

I think that about tells the General Investment Corporation story.

Senator WAGNER. This was all done with other people's money?

Mr. SCHENKER. This was all done with other people's money. Did you understand, Senator, that when they paid for the preferred stock that was deposited up in the Royal Bank of Canada that was bought in by Mr. Groves from the money of the General Investment Corporation which came from the money which had been moved up there? So what Mr. Groves did was to pay the public $87.50 and keep the difference.

Senator WAGNER. Yes.

Mr. SCHENKER. Another little wrinkle, Senator.

Senator WAGNER. But that wrinkle amounted to $400,000, did it not?

Mr. SCHENKER. The wrinkle was the difference between what he paid the public and what he kept himself out of the General Investment Corporation's funds which were used—about $300,000.

The agreement whereby Groves sold this stock to the General Investment Corporation also had a provision in it that in the event that the corporation was liquidated within 6 months he would not get $102.50; he was to get $112. But by that time we had heard about it, and the stockholders instituted suit, and he said, "All right; let's take the $102.50 and forget about the $112."

As a result of this Mr. Warriner and Mr. DeRonde and Mr. Groves have been indicted for conspiracy to use the mails to defraud.

I just want to say one thing, and we will elaborate a little. You may say, "Well, what is the necessity for this legislation? Can you not indict these fellows under the criminal statutes?"

Senator, you have got the toughest job of your life. You have presided over criminal cases, and you know that. It becomes a question of good faith. It is a comparatively simple matter when it involves the selling of the stock of a going concern. The question is, is the stock worth the money? Is there such a discrepancy that you can impute bad faith and felonious intent?

Take the case that Mr. Cook described to you. That case was brought by Tom Dewey's office, up in New York County, and those fellows got away. Why? The district attorney's office had to rely on the tricky theory of larceny. They had to rely on the theory that it was a larceny for those individuals to transport the company's portfolio of securities from New Jersey to New York.

And then you get one of those charges to the jury that "Unless you find felonious intent, intent to steal," and so forth. And the jury says, "Well, they gave him a piece of paper. Who knows whether he intended to steal or not"?

That is why this bill says that you cannot sit on both sides of the table when you are dealing with an investment trust. If you are a director or officer or manager or controlling person you cannot sell

any property to an investment trust, because you are sitting on one side representing yourself where you have a pecuniary interest, and you are sitting on the other side representing the investment trust; and we say that fundamentally that should not be permitted. If that provision had been in effect at the time of the Groves incident and these numerous other cases we will tell you about, then you would not meet this complicated problem of whether the transaction was fair or unfair.

One of the lawyers involved in the *Continental Securities case* told Joe Patrick, of our office, who helped work on the case with me—he said, "Do you think I as a lawyer would have been crazy enough to try to sell the stock to this investment corporation when there was a direct, unequivocal statutory provision saying that a controlling person cannot sell such stock? I was figuring that I was going to go before a jury."

When you deal with investment companies, because of the peculiar nature of their assets—they deal in securities—it is difficult to convince a jury in certain situations.

That is the approach of this bill, Senator. We tried to set forth broad standards to prohibit transactions like the ones that have been recounted, because we know the difficulty of trying to convince a jury of larcenous intent and conspiracy. We say it is fundamental that these people who deal with investment trusts should not be able to do so if they control investment trusts.

Senator WAGNER. Have you concluded?

Mr. SCHENKER. I am through, Senator.

Senator WAGNER. We will hear Mr. Mathews.

STATEMENT OF GEORGE C. MATHEWS, MEMBER OF THE SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Senator WAGNER (chairman of the subcommittee). You are still a member of the Securities and Exchange Commission, are you not, Mr. Mathews?

Mr. MATHEWS. I am.

Senator WAGNER. Unfortunately you are soon to take leave of that Commission and go into private business, I understand. I want you to know that we all regret your departure.

Mr. MATHEWS. Thank you, Senator.

Senator WAGNER. We recognize the very fine service that you have given to the country.

We would now like to hear from you with reference to this legislation.

Mr. MATHEWS. About all that I want to do with reference to the bill now before you is to state as clearly as I can my position on the question of regulation of investment trusts. It is a characteristic of these organizations that, through them, a body of small investors turns the handling of its funds over to others. Even under the most ideal conditions the individual investor is without any means of effective participation in the management which handles his money. Furthermore, a great many investors turn to the investment trusts for the very purpose of turning over to experts the problems of investment management which they do not feel competent to solve for themselves.

Speaking in general terms, the investment trust has not supplied capital to industry. The exceptions have been trivial and unimportant in their relation to our economy. Regulation cannot be charged with having the effect of stifling industry. Again speaking with individual and negligible exceptions excluded, the only real function which makes the existence of these institutions important to the country is that they supply a means by which a great number of investors may own a shore in industry with such advantages as flow from diversification of investment and employment of expert management. At their best, investment trusts serve these purposes. At something less than their best, the reputed advantages of diversification and of expert management are more than offset by the dangers which the mass of investors encounters in them.

Their history sufficiently shows that investors need the protection of effective regulatory legislation and administration.

You have a specific proposal before you. It seems to me too much to expect that proposals for legislation which had not been subjected to the searching criticism of your legislative hearings should represent in all respects what should emerge as law. My study of the reports resulting from the investigation and of the bill as it was introduced convinced me that measures of control provided by the bill which has been introduced were sufficiently supported by the record of the investigation that for us to recommend substantially less would not fulfil our duties to the Congress.

I do not suggest that as it stands the bill is in such a stage of perfection that it may be accepted as ready for enactment without the most critical examination. I have seen too much of the improvement process through which legislation goes after it reaches the stage of legislative hearings for me to take that position.

There is no doubt of the need of effective and comprehensive regulation. A form of control which is less than that may be about as dangerous to the public as complete freedom from administrative restraint. I would be very much opposed to any program which, under the mask of regulation, sought to do more than to impose those restraints upon management which are really necessary for the protection of investors, but any course which does not impose those restraints may be very misleading to those whom it professes to protect. Fortunately this bill deals with a business such that the fullest measures of control required to safeguard investors cannot with any pretense of logic be made to appear to have a depressing effect upon the national economy.

I have no further statement to make. I merely wanted to state my views, Senator.

Senator Wagner. Have you any questions, Senator Hughes?

Senator Hughes. I think not. I understand the viewpoint.

Senator Wagner. I gather from your statement that your knowledge of these experiences comes from a study of the report. You did not yourself participate, I understand'

Mr. Mathews. No. I did not attend the hearings except incidentally and for very brief periods.

Senator Wagner. And your considered judgment, as a result of your study, is that in order to protect the investor in this type of investment it is essential that there be some public regulation?

Mr. MATHEWS. I think there must be some public regulation, and I think it must be far-reaching public regulation.

Senator WAGNER. You do not think that this bill is too extreme in its proposals?

Mr. MATHEWS. I have not been able to see anything in the plan of the bill or its scope, anything of substance, that I could not subscribe to. I would like to make it clear, however, that I have no notion that in every detail of the bill it is just what you want to pass.

Senator HUGHES. I understand that you think that a mere gesture at regulation might be more dangerous than having nothing?

Mr. MATHEWS. I think it would be perhaps worse.

Senator HUGHES. Because it would be misleading, and the people would think that there was something being done, that there was a law that protected them, when it really did not do so.

Mr. MATHEWS. Well, we have all seen the case of States where banking regulation was inadequate. We have seen States where insurance regulation was inadequate. The public, I suppose, relied on the fact that there was such State regulation—relied, to its great loss, on that fact. So that I say there is not a really middle ground. I think if you do not have a comprehensive and effective program of regulation, it is probably better to have none.

Senator HUGHES. Yes; I have seen that. You have the machinery, you have the offices, and people think that the insurance commissioner or the banking commissioner or whoever it may be has all the necessary authority and that he is protecting them, and the thing must be all right, when, as a matter of fact, it is not so.

Mr. MATHEWS. That is right.

Mr. Schenker suggests that I have omitted one thing with reference to the basis for my conclusions. I was in charge of the administration of the State blue sky law for a considerable number of years at about the time that these investment trust securities were being sold very actively, and even before this investigation was started I was convinced of the need of a pretty thoroughgoing program of regulation, although I had not by any means thought the matter out to the point where I could make specific proposals.

Senator WAGNER. I do not see what other answer there can be. One of the very distinguished members of this committee has told me, "I have listened to enough facts to satisfy me that there has got to be regulation." Of course, we want to hear all sides, and also we want to hear criticisms as to the detail of the proposed legislation.

Mr. MATHEWS. If the substance of our reports could be boiled down into a short readable book, I do not think anybody could read it without being convinced of the necessity of regulation. To leave the door open for a repetition of what has happened over the past 10 or 15 years is little short of criminal; and I join with Mr. Schenker in wanting to be understood as not accusing the entire industry; but with the possibilities there, if the ability to market securities should suddenly step up, unless there are restraints in general such as proposed in this bill, the opportunities for going to the public and getting control of their funds would be such that the industry is bound to attract to itself again the very class of people who brought it into bad repute in the past. It could not be avoided.

Senator WAGNER. We are going to hear those who have criticisms of the legislation. The facts that have been related to this committee

persuade me that the Congress would be careless in its duty if it ignored these facts and made no effort in some way to prevent their recurrence in the future.

Mr. Mathews. Commissioner Healy has raised another question with me. We think of investment trusts popularly as a type of business in which a security is sold to the public. The public's money is obtained, and the transaction is closed. Now, there are two other types of institutions within this general field. One of them has characteristically been a trust superimposed on a trust. That is, the assets of the top trust were the certificates of the lower trust, and characteristically the securities of the top trust were sold to the public on a basis which included a load on both of them; those loads meaning, as I recall, from 12 to 20 percent of the underlying assets. They are sold on the installment plan basis, so that they are put in a form to make an appeal to the person who really wants to make a conservative type of investment into which he can put his savings year after year, over a period of 10 or 12 years.

Another type of the installment plan company is the one that issues a fixed amount of certificates, promising to pay back at the end of X years a fixed number of dollars in return for the payment to the institution of so many dollars a month over that period.

Those are peculiar institutions which appeal to the saving instinct in people, the desire to adopt a continuous carefree program of investment.

My conclusions are not entirely final as to some features of the face amount certificate companies, but our experience has beer, I believe it is safe to say, that they would not be alive if it were not for the fact that there is a tremendous mortality of those contracts, with either no recovery to the investor if they are surrendered within an early period, or with a surrender value much less than the amount paid in. Where you have that tremendous mortality, obviously with losses to the people who surrender to help to keep the business going, when perhaps if I held my certificate to maturity it might help me as an investor. But the whole question is raised as to whether they are selling, as to whether the essential nature of the business is to sell to the investor certificates which he holds to maturity, or whether the essential nature of their business is that of a business which is primarily one of selling something to the customer that they know he will not keep and that he is bound to take a loss on.

The experience has been so overwhelming that it may not be unfair to characterize the business as one which is primarily a business of selling to people who are persuaded that they ought to make a conservative investment over a period of years, something which experience shows will never be carried out, and where experience shows that the bulk of the purchasers are bound to lose part or all of their money, because the purchasers do not or cannot keep up their payments.

Senator Wagner. Thank you very much, Mr. Mathews.

Senator Hughes. I am acquainted with some of those experiences.

STATEMENT OF BALDWIN B. BANE, DIRECTOR, REGISTRATION DIVISION, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Senator WAGNER (chairman of the subcommittee). You are chief of the Registration Division of the Securities and Exchange Commission?

Mr. BANE. Yes, sir.

Senator WAGNER. The committee would like your views on the pending legislation.

Mr. BANE. I would like to deal, Senator, with the type of trust that is frequently registered with the Securities and Exchange Commission.

You remember that Judge Healy said that approximately 1,300 trusts, if I remember correctly, had been created in the last 15 years, of which some 650, or approximately half of them, were still in existence.

He also referred, I think, to the peculiar characteristics of investment trusts and to the fact that disclosure under the 1933 act, that is, the Securities Act of 1933, is inadequate as a remedy to prevent certain of the generally admitted abuses in the industry and to the effects of those abuses on the trusts, on the security holders, and on the profits derived by the so-called insiders, the underwriters, sponsors, and dealers.

Although there are about 650 investment trusts at present in existence, only about 265 of the 650 have registered with the Securities and Exchange Commission under the Securities Act of 1933.

Between July 7, 1933, which was the first date that you could register under the act, and December 31, 1939, approximately 4,300 registration statements have been filed under the Securities Act. They cover an aggregate offering of something over $15,000,000,000, and the largest part of that offering is, of course, bonds, debentures, and preferred stock. The common-stock offering is only something over $4,000,000,000. Of that $4,000,000,000 which can be compared to the type of securities sold by the ordinary investment trust, because the security ordinarily sold by the investment trust is merely an equity security, we have registrations from these investment trusts of more than 50 percent of that total of $4,000,000,000. That is something over $2,161,000,000 registered with us under the Securities Act by these so-called investment companies.

Of the 265 that registered with us, as near as we can determine from a recent survey only approximately 130 of them are now in existence, and not all of the 130 are at present actively selling.

These investment trusts are as easy to form as they are to disappear. In fact, it is probable that they are too easy to form. Practically all you have to do is to draw up a so-called trust indenture or agreement, setting up a so-called trustee who, in reality, is little more than a custodian, granting powers to the managers and sponsors, limited only by the consciences of those managers and sponsors. Then you start manufacturing your securities and peddling them to the public.

Senator WAGNER. There is nothing in the law that prevents that, is there?

Mr. BANE. As it stands today, no, sir.

As a general rule, a small block of securities is first offered to the public at a fixed price, in order to secure money to buy securities for

the portfolio of the trust, and after that the securities are sold at a price based upon the value of the securities in the underlying portfolio.

These securities, we have found, are generally sold as an investment to persons of small means and as an alleged safe investment to people who understand saving but have little knowledge of investment.

As great an advantage as are disclosure and publicity, and as the Securities Act of 1933 has shown them to be, there are certain practices generally engaged in by investment trusts and so generally admitted, even by the members of that industry, to be bad and of such evil effect that they should be either restricted or entirely prevented, and particularly when you consider the type of person to whom the securities are principally offered and the complex and technical nature of many of these abuses and the effects that flow from them.

I want to point out just a few of those abuses which this bill will either wholly prevent or tend to prevent; and I am going to talk not about the type of investment trust that you have been hearing most about, as I understand the hearing so far, but the type that is mostly registered with us. It is a type that originated largely and has grown in the thirties. That is the open-end management investment type—meaning a management company which is offering its securities for sale or has outstanding redeemable securities which it has issued. This type, as I said, constitutes by far the largest type registered with the Commission.

The companies of this type sell unissued and redeemed securities to the public at a price determined by the market value of the securities in the portfolio of the trust as of a particular time each day, and the moneys thus raised are used to buy additional securities for the portfolio.

The theory back of these trusts is that the new member should pay for his share an amount equal to the proportionate equity of the existing shareholders at the time the new member comes in. In most of these companies practically all of the portfolio securities are listed on either the New York Stock Exchange or the New York Curb Exchange. Because of this listing the value of the portfolio can readily be calculated shortly after 3 p. m. each day. That is the time at which the New York market closes. From this value all liabilities of the trust are deducted, and the resultant figure is divided by the number of shares outstanding, and that gives you what is generally referred to as the net asset value per share. To this net asset value there is added what is generally called a load, which means a certain percentage of that value, generally about 8½ percent, though it varies among trusts, is added to cover all selling costs, and the profits for the distributors.

This price determined shortly after 3 o'clock each day, as a general rule among the trusts, is practically never used as a basis for the sale of these securities as soon as it is determined. It varies among the trusts, but generally it does not go into effect until 10 a. m. the next day. The price which went into effect at 10 a. m. on any day remains the same until 10 a. m. of the next day, even though the value of the securities in the portfolio, and therefore the net asset value of the shares, is substantially higher in the interim because of a rise in the market price of the underlying portfolio securities.

The fact that the price from 3 p. m., or approximately that time, to 10 a. m. the next day is less than the price to go into effect at that time,

that is, at 10 a. m., is stressed repeatedly in order to sell these securities to the public. It is used as one of the principal selling arguments.

Thus there are two known and determined prices in existence in such cases from shortly after 3 p. m. to 10 a. m. of the next day, practically for 19 hours out of every 24.

Let me contrast this situation with that of the ordinary purchase of a listed security.

One walks into a broker's office about 10 or 10:15 in the morning and asks what the price of United States Steel common is, for example, and he is told $55 a share. He decides he will wait a while and see what the market does. He learns some time later in the day, after the market has closed, that U. S. Steel closed at $59 a share, up $4 above what it was in the morning. He probably wishes that he had bought steel at $55. But now he cannot buy it at less than $59, because even though he buys after the close of the market, that market close is generally the price that will prevail until the opening of the market next day.

In the case of investment-trust shares, however, the situation and the basis of sale are entirely different. Even though the securities in the portfolio and, therefore, the asset value of the trust certificates, just like Steel, General Motors, General Electric, or any other securities listed on the exchange, fluctuate—for example, assume that at 10 o'clock in the morning the shares of a particular investment trust are selling at $55, these investment trust shares of course will change in value, but not in price, throughout the day as the price of the underlying portfolio shares changes. Let us assume that at 3 p. m. when the stock market closed the underlying portfolio shows that the trust share now is worth $59. Every one knows that the trust share has risen $4 in value at that particular time.

However, there is one big difference right there between buying Steel stock and buying the stock of this investment trust whose value depends upon stocks like Steel listed on those same exchanges. People who wish they had purchased steel shares at $55 cannot do it; but the person who wished he had purchased the trust shares at $55 may still buy those shares at $55, and in the usual case he may still buy them at $55 up until 10 o'clock the next morning. In other words, he can buy a share at what is then known to be $4 below its worth. If we suppose that he has one share, that one shareholder now has an appreciation of $4 in his share; but the other man, knowing that he can buy into the same thing for $4 less than that, $55, buys in, and another Steel share has to be put into its place which has to be bought at $59, or if the market goes up it may have to pay as high as $61 or some other figure. He gets another Steel share in there, but he gets a portfolio interest in there at $55.

This one man who had a share at $55 now finds two shares in at $55. The $4 appreciation that he had in the portfolio has been divided between the two. So the appreciation earned by the one share in the trust has been cut in two.

That is what is generally referred to in the investment-trust industry, and that is what I will refer to when I use the word here, as dilution. The interest of that first security holder has been diluted by allowing the second security holder to go in and purchase at less than the value of the share at the time he bought it.

The extent of that dilution depends, of course, upon various factors, the amount or the difference in price between that at which

he could buy and the actual value, the size of the trust, and so forth, and the amount that you sell, as compared with the amount already in the trust.

This example demonstrates the principle upon which the little understood two-price system, to which I will refer throughout this discussion, in the investment-trust industry, works.

The two-price system is, in the financial world, I suppose, a distinct peculiarity of the investment-trust industry. In substance, in this industry people are urged to buy trust shares at a time when it is known that the price to go into effect at a later determined time is higher than the current offering price of the shares, and they are urged to do it, to the dilution of the trust, by buying at the lower of the two prices, even though the shares are worth the higher price.

Conversely, the two-price system affords the purchaser the opportunity to withhold his order until the following day, when he knows that the new price to go into effect is lower than the current offering price.

The two-price system results in a substantial dilution to the trust, and some of the trusts have quite recently taken steps in an effort to reduce, to some extent, the amount of that dilution, by shortening the time within which these two prices are in effect.

The great volume of sales in investment-trust securities, from 70 percent to 90 percent, are made on a rising market—that is, when the next day's price will be higher than the present price. When the market is down—nobody wants to buy.

Several bad results flow from this. The salesman is able to and does go out and offer the securities at less than their known and established values. In many instances he is urged to do so by the sponsors and underwriters, those occupying the fiduciary relationship to the trust.

When the securities are sold at less than the value as established from the portfolio of the trust it means that the trust does not receive sufficient funds to buy the proportionate interest in the portfolio as represented by the securities sold, and thus the interest of all present security holders is diluted, the extent of such dilution depending on the size of the portfolio and the sales made at the lower price.

This dilution occurs whenever securities are sold at less than the proportionate value which they represent in the trust, regardless of whether two established and known prices exist at the same time. For instance, if prices were determined each day shortly after the close of the market at 3 p. m., and no sales were made thereafter except at the price thus established and the market rose during the next day, there would still be dilution as long as shares are sold at prices at the close of the market of the preceding day and that close was lower than the price during the next day.

The two-price system merely accentuates that dilution and enables it to be used as, and it is used as, one of the principal selling arguments by many of the open-end investment trusts.

In September 1939 the stock market took quite a rise, and we undertook a study to determine the effect on the trust, the existing security holders, the underwriters, and those who came in during the period from September 1 to September 21, of dilution resulting from the two-price system.

We sent out a questionnaire to all of the investment trusts registered with us that we had any idea might be active, about 176 in number.

We got back replies showing that about 78 of them were active in the sales of the so-called equity securities.

We made a very careful study of those 78 and we found that those 78 trusts did many times as much business as is normally done on that 1 day, whereas the volume of business on the New York Stock Exchange was twice as much. We found, for example, that on September 5 these 78 trusts did 83 times as much business as was normally done by them in 1 day. More particularly, we found that certain well-organized trusts which had been in operation for a number of years sold more in that 1 day than during the entire previous year.

In one instance we found that a trust, organized and operating since 1933, with an effective selling group, sold 11½ times as much in that 1 day as had been sold in the previous year, or practically 4,000 time the normal sales of 1 day. Several other companies sold amounts varying between as much as and 9 times as much in that 1 day as in the entire past year.

Of the 78 companies—this will be restricted still further, Senator—approximately 15 do not employ, or on this 1 day did not allow, sales under the two-price system, so the figures I have given you relate to practically 60 companies, and as a result these 15 companies did not effect sales larger than sales normally made on the average day, whereas the remaining 60 companies accounted for this great increase in sales.

Let me give you one actual example. Beginning at 10 a. m., on September 5, the value of each outstanding share in this trust, which had been computed at the close of the market on September 2—you will remember the 3d was a Sunday and the 4th was Labor Day—was $5.60, and by 3 p. m. on September 5—that is on September 5 the market for that particular share opened at $5.60, and that was the price because it was the price computed at the close of the last market day on September 2—the value of each share so outstanding had risen to $6.70 a share by 3 p. m., an increase of 19.6 percent, or $1.10 per share.

The company, however, continued to sell shares at $5.60 until 10 a. m. the following morning, with the result that approximately $133,045 did not go into the trust which would have gone in had the shares been sold at their true value.

The dilution of this trust in that 1 day was more than $133,000. However, the effect upon the shareholders, who had been in the trust for many years in many instances, was disastrous. For many years they had been waiting for just such an appreciation, which apparently took a war to cause. In other words, the man in that trust, instead of having a value, after that day's sales were over, of $6.70 per share, which he would have had at 10 o'clock on the morning of the 6th, had a value in them of only $6.04. The other shares, in other words, that had been sold in that day had diluted him until his share was $6.04.

Senator Wagner. Where did the $133,000 that should have gone into the trust go?

Mr. Bane. They did not pay it. They sold the share for $5.60 when the share was worth $6.70, so the $133,000 should have gone into the trust in return for the share as a price for the share to the new

buyers. It did not go into any particular individual's hands. It resulted from the failure to sell the share at the value of the share. The shares sold for $133,000 less than they should have been sold for, that is, what they were worth.

Senator WAGNER. What was the motive for that?

Mr. BANE. One of the chief motives, as the investment trust people say and as they used it, is to promote sales.

Senator WAGNER. That is what I had in mind.

Mr. BANE. One of the principal motives is that, and there are other advantages, of course. When you promote sales in this way you increase underwriting commissions. When you increase the size of the trust by the addition of these new sales, you increase management fees, because management fees are generally based upon the size of the trust.

The total dilution in these 60 trusts on that 1 day, September 5, 1939, was $1,585,484, and this one example I gave you, Senator, of over $133,000 dilution of one trust in 1 day was not by any means the largest dilution that we encountered for that day.

We found one trust in which the dilution ran as high as $392,182.

On September 11, 1939, and September 19, 1939, similar studies were made, and it was found that dilutions aggregating $72,000 on September 11 and $104,000 on September 19 were suffered by these trusts. Now, granted, which we do, that September 5 was an unusual day, no one can contend that the market fluctuations on September 11 and September 19 were in any way abnormal. As a matter of fact, over the past 9 years the Dow-Jones industrial averages change more once each 3 weeks than the changes in the market of September 11 and September 19.

As an over-all picture, the 78 trusts suffered dilution or, in other words, were weakened, more than one and three-quarter million dollars in these 3 days in September, and the old purchasers, the holders of the shares, were deprived of a substantial part of the appreciation that would have accrued to them.

Many of these trusts that I am talking about will redeem their securities at the net asset value of such securities, less a small charge, as of the close of the day on which the shares are presented for redemption.

Senator HUGHES. Excuse me just a minute, if I may interrupt you.

Mr. BANE. Yes, sir.

Senator HUGHES. That money was lost?

Mr. BANE. It was lost insofar as the trusts were concerned.

Senator HUGHES. It went into the fees and commissions, and things like that?

Mr. BANE. No, sir; I do not want to give you that impression.

Senator HUGHES. What?

Mr. BANE. No, sir; I do not want to give you that impression. When I say that one and three-quarter million dollars was lost, I mean the trusts lost it. I do not mean that any particular individual in the trusts got that money. He did not. I mean that the shares sold on those 3 days in those trusts were sold at a million and three-quarter dollars less than they should have been sold for, and to that extent you lessen the interest of the man who already held in the trust.

Senator HUGHES. They brought in more purchasers, they brought in more stockholders, and that is the way it was diluted?

Mr. BANE. That is right.

Senator HUGHES. And that did increase the fees?

Mr. BANE. But not to that extent.

Senator HUGHES. Not to that extent?

Mr. BANE. It increased the underwriting commissions. They made large underwriting commissions.

Senator HUGHES. I was trying to find out what became of that loss, whether somebody got it.

Mr. BANE. I did not hear you, Senator.

Senator HUGHES. I say, I was trying to find out what became of that loss, whether it really was a loss of whether somebody got it. It was a loss of the people who had an interest in it?

Mr. BANE. That is right. To that extent these trusts, or the interests of the shares of the holders in those trusts, were diluted, so if he attempted to sell those shares, the shares were worth that much less—not exactly that, because the other ones would have to go into that—but it is true that that amount of money did not go to the managers of the trusts. The underwriters of the trusts did make on that day something over a million dollars in underwriting fees. Because the size of the trusts increased and the management fee is based upon the size of the trust, the management would get increased management fees, but I do not want to indicate that one and three-quarter million dollars went into the hands of those particular persons.

All of these companies will redeem their shares. Many of them will redeem their securities at the net asset value less a small charge as of the close of the day on which the shares are presented for redemption.

Senator HUGHES. Is that what is referred to here as the open-end?

Mr. BANE. I am talking about the open-end; yes.

Thus, in a rising market, when the rise results in an asset increase of the share, greater than the load that is added to cover sale commissions and profits; a person can buy a security, after the two prices are known and established, at the lower of the two prices and almost immediately turn in the share for redemption for a higher price without any chance or risk of loss; he can't lose.

For instance, let us assume that this company—and many of them will—redeemed its outstanding shares at the price of the share on the day on which it is presented. Take the same figures that were used before. We will assume that the share is sold on that day for $5.60. He presents some shares he has for redemption. They are redeemed at the prices at which the market closes that day, and it closed that day at $6.70. Now, you have got that $5.60 and $6.70 price in existence from 3 o'clock until 10 in the morning. This is something which, of course, the average person to whom a security is offered does not understand.

He can buy that share or a thousand of those shares at $5.60 and he can turn them right back and say, "Give me my money. Give me $6.70 for them."

We know companies that do it, and it has been done. There are companies that redeem their outstanding shares as of the price of the share at the close of the market on the day on which the share is presented for redemption up until 4 o'clock in the evening. If this company is selling shares at $5.60, you can buy your share at $5.60—and the price has risen to $6.70 during the day, we will say—present

it for redemption before 4 o'clock, and get $6.70, and that has been done—another result of the two-price system.

In other trusts where they do not redeem except on the basis of the next day's sale price, and there are some of them, the same thing will follow. He can wait, having bought today, after the close of the market, at $5.60, or he can wait until a quarter of 10 tomorrow morning and buy at $5.60, and when it opens at 10, hand his share in and get $6.70. There are trusts that redeem upon that basis.

There are other investment companies which will not redeem shares except at the net asset value less a redemption charge as of the close of the day succeeding that upon which the shares are offered for redemption. In such cases, of course, there is a slight risk involved, but in a generally and rapidly rising market such as occurred in September the risk is very slight.

We found in our study for September that some insiders—that is officers of the sponsors, managers, and underwriters—took advantage of the two-price system to buy shares before the advance price went into operation and then almost immediately redeemed them at the higher known price.

Senator WAGNER. Were they substantial sales?

Mr. BANE. Only in a few instances.

Senator HUGHES. You would have had to have money to do that; you could not manipulate that from a shoestring?

Mr. BANE. I presume the trust made them pay for it, but being inside the trust, I do not know how good their credit was.

Senator HUGHES. Very good, I would say.

Mr. BANE. I would say so.

We also discovered that there were sometimes dealers—and I do not mean dealers selling these securities now—who made a more or less regular practice of purchasing shares and immediately offering them for redemption, at a profit.

There were two or three of those dealers in this period in September who made a substantial—they, however, were not connected with the trusts—profit by doing just that on September 5—in other words, raiding the trust.

Senator HUGHES. It is a wonder there were not more.

Mr. BANE. That is the marvel of it, Senator Hughes. Of course, the type of person to whom this security is ordinarily offered and sold very seldom does it because he does not realize that he can do it.

We found that approximately one-third of all the shares sold on September 5, 11, and 19 were redeemed before September 22, leading to the conclusion that purchasers of about one-third of the shares sold did not purchase for investment but rather for trading; and let us see what the effect of that trading allowed under this two-price system was on the trust:

The trusts paid out for those shares redeemed $338,119 more to redeem those shares than the trusts received for them. Possibilities of profiting through the two-price system are almost unlimited for unscrupulous dealers, sponsors, and others able to buy in large quantities and avoid part of the load, because when you buy in a certain quantity there is a smaller load. Of course, on days like September 5 you could buy the shares, pay the full load, sell them back almost immediately, and still make a substantial profit without any chance of loss except to the trust.

In about 90 percent of the cases we studied the same persons act as investment managers and also as underwriters. They receive a fee which in most cases is about one-half of 1 percent of the total net asset value for managing the trust and protecting the assets, whereas in another capacity, as underwriters, they sell the shares at a value which dilutes the trust assets, and receive the "load" on the sales.

It is to their advantage, of course, to increase the size of the trust, because that increases the management fee. It is to their advantage to sell as many securities of the trust as they can, because that increases the selling commission.

During the period in September I referred to, numerous telegrams were sent by these sponsors and underwriters pointing out to dealers that shares could be bought at a price substantially below what they were then worth and urging that advantage be taken of this situation before the price changed. In one instance the underwriters offered dealers additional commissions on all sales they could secure and ended the telegram by saying in effect that this provided a wonderful opportunity for trading.

It is apparent that this opportunity to buy something for less than it is apparently worth at the time is one of the main selling arguments used by the trusts. It is also apparent that this conflict of interest has worked to the detriment of the trust and to the security holders in the trust.

These trusts always use other people's money. Very few sponsors, underwriters, or managers have substantial investments in these trusts. Many of the persons whose money these trusts have been using had undoubtedly been in these trusts for years, waiting for some real appreciation. It took a war to produce such. And what happened? The managements they had paid to look after their interests sold them down the river so that they lost anywhere from less than 1 to 60 percent of their appreciation, which they had been waiting for. The new purchasers on September 5 bought their shares at a price based on a net asset value of 11 percent, on the average, below the actual net asset value at the time of the purchase.

It is only fair to say that since our questionnaires were sent out in October on the September situation I have been talking about some companies have attempted to rectify the matter by reducing the number of hours two prices exist. One or two companies have attempted even to go further and price their shares twice a day. Many of them, as I say, have reduced the number of hours in which the two prices are in effect. However, it is obvious that a mere reduction in the number of hours does not prevent dilution but merely causes the dealer and his customer to act more quickly if advantage is to be taken of the two-price set-up.

Further, some dealers and underwriters have worked out a method which to a large extent sees to it that their new purchasers do not lose, buy at the higher of the two prices, but still they work a greater hardship on the man in the trust, and that is a continual thing from day to day, from year to year. They mark their orders N. A. or S. L., when they send them in, meaning that the order is to be held until just before the next advance in price, meaning still that the more you buy, the more you dilute the interest that the man has in it, and meaning, in the case of S. L., that the orders are to be held if the market is looking down. In the same way, in some of these trusts,

you can present your share for redemption and ask that it be held to be redeemed at the next advance instead of at the time you offer it.

It seems almost incredible that after paying 8½ percent to cover selling cost and a profit to the distributor and paying in addition the same person, as manager, one-half of 1 percent per year of the money which you have invested, for the purpose of having him handle in a fiduciary capacity, and protect and enhance your assets, he would sell an interest comparable to yours worth $6.70 for $5.60 and thus lessen the value of your interest, so that he might make himself an additional underwriting commission and an additional management fee. It doesn't make sense, but investment trusts do it.

In addition, there are dealers under this system who can, and some do, withhold orders until these two prices are determined and known, and if the price to go into effect next morning, for example, is lower than the price at which the dealer accepted the order, he will hold the order until the lower price goes into effect and send the order in at the lower price, pocketing the difference. He can't lose.

If the next price is to be higher, he will send the order in at the lower price at which he accepted it, a practice by which he cannot lose but he is not bound to win.

Likewise the dealer, when he knows these two prices and the next day's price is to be higher, can, and many do, buy in advance of orders at the lower price and sell the shares the next day at the higher price, pocketing the difference, all to the detriment of the trust.

In the 78 cases that we studied that replied to our questionnaire, practically all of the underwriters also act in a fiduciary capacity as managers or sponsors of their respective trusts, and yet in 50 of the 78 cases no effort was made to prevent dealers thus taking positions against the trust.

I would like to give you an actual illustration of a case we had in the Registration Division. Sometime ago we encountered an investment trust sponsor and underwriter who was found to be purchasing shares in advance of the orders received by him and conversely holding back orders placed with him by dealers and purchasers until such time as it was advantageous for him personally to fill these orders or sell from the shares purchased by him in advance of orders.

This sponsor sold trust shares to the public directly and to four or five so-called installment plan companies. Each day after 3 p. m. this particular sponsor or underwriter valued his portfolio as of the close of the New York market. He found the net asset value and divided it by the total outstanding shares. This gave the net value per share. Let us assume that this is Tuesday, and he finds that each share is worth $1.10 without the load charges. This price of $1.10, however, does not go into effect until Wednesday morning. This sponsor employed dealers and salesmen and they begin selling at $1.10 net.

Generally, about 3:30 p. m. Wednesday afternoon they begin to send in the orders. Orders are accepted by the sponsor all afternoon, evening, and until the next morning at 10 o'clock. The sponsor knows the sales are being made at $1.10 net.

Shortly after 3 o'clock p. m. on Wednesday he figures the price again of the net asset value of the shares and finds that it is $1.06. He has gotten orders at $1.10 a share. Does he fill them? No; he puts them in his drawer, so to speak, until the next day, when he can fill them at $1.06 and make a profit of 4 cents a share.

Thursday's orders come in and he has received orders on the $1.06. He values them again and sees they have declined to $1.03. He has got more orders by Thursday. Does he fill them at $1.03? He does not. He has figured his price and found it is lower again, so he puts them in his drawer again.

This particular sponsor did it for 19 consecutive days. The price kept sinking until it declined from $1.10 to 88 cents per share. On the nineteenth day the market jumped up to 96 cents, and then at 88 cents he bought all the shares necessary, something over 190,000 shares, to fill the orders he had, and put the difference in his pocket, and to that extent diluted that trust.

Senator WAGNER. That amounted to a substantial sum of money?

Mr. BANE. A substantial sum of money.

Senator WAGNER. Do you know how much?

Mr. BANE. For a short period it amounted to $25,000. We figured out that for a period of 10 months it amounted to about $60,000.

Senator WAGNER. This one case?

Mr. BANE. This one case. He did not stop there at merely filling all those orders that had been accumulated at higher prices at 88 cents. He knew the price was going to be 96 cents the next day, so he bought another 190,000 shares at 88 cents to offer them the next day at 96 cents. If he could not sell them all and the market took a sudden drop, he might take a loss, but it was unlikely, because he knew that the large volume of investment-trust shares is sold on a rising market, and here he had these 190,000 shares at 88 cents and he had these four or five installment plan companies that were buying from him, and he knew he could dispose of part of them there, as he could gage their orders.

The effect, of course, of all of that was to impair very seriously the interest of the shareholder already in the trust, the man who had been paying him to look after his interest, and he, the fiduciary, taking a position against him on which he could not lose. It was impossible to lose on the short position; he might have lost on the long position, by a long chance.

We issued a stop order against him, and that was as far as we could go. We obtained a stop order to discontinue sales because of his failure to disclose material facts. The Commission wrote an opinion in that case, known as the case *In the Matter of T. I. S. Management Corporation.* If you would like to have that opinion for the record, I have a copy of it here.

Senator WAGNER. It may be inserted in the record.

(The document is as follows:)

[For immediate release Friday, February 25, 1938]

SECURITIES AND EXCHANGE COMMISSION,
Washington.

(Securities Act of 1933, Release No. 1689)

UNITED STATES OF AMERICA, BEFORE THE SECURITIES AND EXCHANGE COMMISSION

In the Matter of T. I. S. Management Corporation. File Nos. 2–1303, 2–2316, and 2–3485

FINDINGS AND OPINION OF THE COMMISSION

This is a proceeding under section 8 (d) of the Securities Act of 1933 to determine whether stop orders should issue suspending the effectiveness of three registration statements on Form C–1 filed by the T. I. S. Management Corporation, hereafter referred to as the "registrant". These covered blocks of 862,069 shares, 3,000,000 shares and 18,000,000 shares of "Trusteed Industry Shares," an unincorporated investment trust of the restricted management type. The registrant acts as depositor and sponsor of the trust and hence is the "issuer" of the trust shares.[1] The registration statements became effective on April 20, 1935, as of April 15, 1935, August 8, 1936, as of August 5, 1936, and November 29, 1937, respectively.

These proceedings were commenced through confirmed telegraphic notices to the registrant on December 4, and December 6, 1937, citing misstatements or omissions in items 28, 36, and 38, exhibit D, and the prospectus of each registration statement. The principal deficiencies are alleged to result from the registrant's failure to disclose its practice of trading for its own account in the registered shares in connection with their distribution and the full extent of the profits which it had thus realized at the expense of the trust and the shareholders. In accordance with the notices a hearing was held before a trial examiner on December 14, 1937, at which it was stipulated that the evidence introduced should be applicable to all three registration statements.

At the hearing the alleged omissions were admitted and consent was given to the entry of stop orders. However, the registrant specifically denied the materiality of the omitted information.

On December 2, and December 10, 1937—that is, before the commencement of the hearing—the registrant filed proposed amendments to all three statements in an attempt to correct the alleged omissions. Under section 8 (c) of the act these amendments become effective only upon declaration by the Commission.

The trial examiner has filed an advisory report in which he found that the registration statements omitted to state material facts as alleged. Although registrant has filed exceptions to this report, it subsequently stated in a letter to the Commission dated January 12, 1938, that instead of pressing its exceptions it desired to petition the Commission:

"(1) To declare effective forthwith the amendments filed by the registrant after the effective date of the latest registration statement, and (2) to exercise its discretion in favor of a dismissal of the stop order proceedings."

In support of this petition, the registrant argued that the omissions were not material; that there is no evidence of an attempt to mislead or defraud investors but only, at most, mistakes as to matters concerning which reasonable men might differ. that in sympathy with the purposes of the Securities Act the registrant has attempted to cooperate with the Commission and to correct promptly the alleged omissions; that the registrant will promptly supply all its shareholders with copies of the post-effective amendments if they are declared effective; that the issuance of stop orders would in this case cause an irreparable injury to the registrant; and, finally, that niether the public interest nor the protection of investors would be served by stop orders.

Therefore, as the case now stands, we need only determine whether the admitted omissions are material, and, if so, whether we should consider the post-effective amendments in reaching a decision on whether stop orders should be issued.

[1] Section 2 (4) of the Securities Act of 1933. See *In the Matter of Underwriters Group, Inc.*, 2 S. E. C. — (1938); Securities Act Release No. 1653.

The registrant is engaged in distributing Trusteed Industry Shares through dealers or to subordinate investment trusts which, in turn, sell monthly deposit plans to the public using the proceeds to buy Trusteed Industry Shares. The trust agreement provides that the trust shares are to be sold only to the registrant. Although this agreement fixes the terms as between the trust and the registrant, the price and conditions of resale by the registrant are not determined by the trust agreement. However, full description of the terms and conditions upon which registrant may resell the shares is required by the Securities Act of 1933.

The admitted omissions are the same in each of the three registration statements except for a minor difference in figures. A discussion of one registration statement will suffice for all. We shall refer particularly to the representations made in the latest registration statement.

Item 36 requires disclosure of

"the method by which the price of the certificates to be sold is calculated, giving a full statement of all of the component parts thereof, including the so-called service or loading charge."

In order to understand the full load involved in the distribution of the securities here considered, it is necessary to discuss the price at which these shares are created and issued by the trust to the registrant, and then compare this with the price at which the registrant passes them on to purchasers.

By the terms of the trust agreement the price paid by the registrant for Trusteed Industry Shares on any particular day is based on the bid prices on the portfolio securities held by the trust as of the close of the previous day's securities markets. To the aggregate of the securities, valued at their bid prices, and the cash in the trust, certain brokerage fees, taxes, and accumulated dividends are added, and this total is divided by the number of shares of the trust outstanding in order to determine the price to the registrant of each share. On the other hand, the registrant itself bases the price at which it resells the shares, not on the bid prices, but on the previous day's closing sale prices of the trust's portfolio. To the total of this valuation plus brokerage and tax charges the registrant adds 9½ percent thereof as its premium. If a fractional cent results from this computation of the resale price of the trust shares, the registrant charges the next full cent and retains this so-called breakage as part of its profits.

Furthermore, the registrant purports to act as a principal rather than as an agent, not only in selling shares to others but also in purchasing shares from the trust. Because of this fact, registrant can buy shares from the trust in such quantities as it desires and thus can take long or short positions in the shares to its own profit. It has been its practice to make delivery approximately 4 days after orders are received. Since it has also been its practice to buy new shares from the trust only after the close of the market on each day at a price fixed by the market on the preceding day, it has been able to determine with precision the following day's sale and resale prices and has been able to use this knowledge to its own advantage. Thus, if it has taken orders during today for a certain number of shares (the prices of which orders are fixed by yesterday's markets), it can determine at the time set for its purchases from the trust whether tomorrow's prices will be lower or higher, since tomorrow's sale and resale prices are fixed by the close of today's market. These short positions can be maintained for a period of 4 days until delivery is required. Consequently, it has been customary for the registrant to buy less shares than its orders call for, when the next day's price will be lower, and, conversely, to buy in anticipation of the next day's sales when the price will be higher.

The evils of this practice are graphically illustrated by the fact that on or about October 21 or 22, 1937, immediately after the severe market break of October 19, registrant bought 190,000 shares from the trust at depressed prices with which it covered its existing short position at a substantial profit. Thus the misfortunes of the trust and its shareholders were turned to registrant's advantage. Registrant's trading positions have in fact resulted in a profit of approximately \$25,000 for the 9 months ended September 30, 1937. Dealers can also take similar positions and similar profits as a result of information on next day's prices supplied by the registrant. Necessarily, the positions taken by the registrant, and by others in distributing the shares diminish the dollar amounts being paid into the trust, since, in effect, investors pay the current prices whereas the trust receives the lowest prices, the registrant keeping the difference. Indeed registrant admits that this practice, to the extent that it produces profits to it results in the trust's being deprived of funds which would otherwise flow to it.

In answering item 36, the registrant disclosed only the method of computing the offering prices and the fixed 9½-percent premium charged by it in selling the

shares. Counsel for the Commission contended that the terms "service" or "loading charge" as used in item 36 included the gross profit accruing to the registrant, that is, the difference between the amount purchasers paid it and the amount which the trust received. On this theory it was contended and admitted that the registrant should have disclosed: (1) the profits made by taking long and short positions; (2) the difference in the original sale price to it of the trust shares figured on bid prices on the underlying securities and the offering price figured on their closing sales prices; (3) the fact that registrant also receives 9½ percent on the difference between the bid price and the last sale-price valuations of the trust shares; and (4) that a profit resulted to the registrant from fixing the price at the next full cent when fractions were involved.

We believe that all of these factors are material in determining the load and should have been disclosed.

The registrant argued that the long and short positions taken by it were immaterial in their effect on the trust, since when it took a long position on a rising market the trust received the funds earlier than it otherwise would, and could invest the receipts in securities which would rise in direct proportion to the registrant's gains. Likewise, it was contended, when the registrant took a short position, the trust did not have the funds to invest in the falling market and could invest them later at the lower prices when payment was made. This argument does not take into consideration the fact that the registrant buys the shares after the close of the market on the basis of the market for the previous day, and that the trust cannot invest the funds at the same prior market prices which determined the amount paid by the registrant. Furthermore, the argument disregards the time lag between payment to the trust and subsequent purchases by the trust for its portfolio, as well as the inability of the trust to take advantage of the daily market fluctuations.

The registrant also argued that under the terms of the trust agreement it has the right to take positions. If the registrant's argument is that the mere fact that it has the right to trade in the shares is due notice to shareholders that it is exercising the right, we cannot agree. The power to buy and sell the shares is necessary in order that the registrant may meet its orders, but certificate holders are given no notice that the right would be exercised in order to make trading profits in addition to the 9½-percent premium specifically set forth. Nor do we believe that the registrant's balance sheets, which show that it was taking positions in the securities, can cure the failure fully to disclose the information as to its profits required in the answer to item 36.

It may be noted that the short positions taken by the registrant involved no risk and perfect assurance of gain. The long positions involved only the slight risk that the relatively even demand for shares in the trust would not materialize before the market turned down.

With respect to the omission to state that the methods of calculating prices for the creation and issuance of the shares to the registrant and for the price at which it resells them were different, the registrant asserted that both the trust agreement and the sample make-up sheet included as exhibit D to the registration statement gave notice of the difference. We recognize that it may be possible for an investor to deduce from the trust agreement and exhibit D that this differential between the sale and resale prices is a further source of profit to the registrant. However, this disclosure in the exhibits is more than offset by the fact that the answer to item 36 does not refer to the trust agreement at all. We have often held, and we now reassert, that items must be answered in such a way that a reasonable examination of the particular item of the registration statement will disclose either by inclusion or appropriate reference the material facts. (*In the Matter of Income Estates of America, Inc.*, 2 S. E. C. — (1937); Securities Act Release No. 1480: *In the Matter of Underwriters Group, Inc.*, 2 S. E. C. — (1938); Securities Act Release No. 1653; *In the Matter of Ypres Cadillac Mines, Ltd.*, 2 S. E. C. — (1939); Securities Act Release No. 1652. Moreover the answer to item 36, although it does refer to exhibit D, gives no notice that it contains information showing a difference in the offering and creation prices. Finally, the computation of the creation price in exhibit D is labeled "For Trustee's Fees and Deposits." Thus even a close examination of exhibit D might not disclose to an investor the method of computation by which the price to the registrant was fixed.

If an investor is not made aware of the difference between the creation and offering prices, he could hardly be expected to understand that the registrant has been receiving not only a premium equal to 9½ percent of the amount paid into the trust but also 9½ percent of the difference between the bid price and the last sale price valuations for the trust shares.

As to the profits from the "breakage" on fractional cents resulting from the computation of the offering price per share, the registrant asserts that its answer to item 36 gives notice that the price is set at the next highest cent when fractions of a cent are involved. The answer to item 37 also makes the same disclosure. However, this is not notice to buyers that the fraction involved is in fact retained by the registrant as distributor of the shares. A reader of the registration statement or prospectus might equally well believe that the trust rather than the registrant received the benefit of the "breakage." The investor is entitled to have this ambiguity expressly resolved.

In addition, the registration statement does not show that the offering price is arbitrarily determined by the registrant without any limitations being imposed by the trust agreement.

Finally, the materiality of these practices is amply demonstrated by the fact that the gross profit from these four sources of registrant's income approximated $37,000 for the first 9 months of 1937. We, therefore, conclude that the answer to item 36 is deficient. The discussion under item 36 applies equally to the omissions alleged and admitted in the answer to item 38, which requires a statement of the "service" or "loading" charge in terms of a percentage. We, therefore, find the omissions in item 38 to be material.[2]

It is alleged and admitted that the various omissions in answer to all the above items and in exhibit D are carried over into the prospectus. However, the registrant appears to argue that these omissions are not material, since notice was given of additional profits through the statement on page 7 of the prospectus dated November 29, 1937:

"There are or may be additional sources of profit. The difference between the last sales price of the underlying securities (which establishes the offering price) and the bid prices of the underlying securities (which is the basis upon which new shares are issued by the trustee): The difference that results when in computing the daily price a fractional result makes it necessary to set the price at the next higher cent: In the event and to the extent that fees collected by the trustee under the trust agreement exceed fees that are guaranteed and payable to the trustee by the depositor."

This statement, of course, gives no notice of the portion of the load caused by the depositor's taking long or short positions. Insofar as it gives notice of the other omitted portions of the load, it states them as a possibility rather than as a certainty.

Moreover, a further misleading statement in the prospectus is alleged and admitted, namely, the statement that "estimated net proceeds accruing to the investor (are) approximately 91.3 percent." This figure is reached by the estimat that the 9½ percent premium when added to the basic selling price amounts to 8.7 percent of the total selling price, leaving 91.3 percent to accrue to the trust.[3] This is not an accurate estimate of the proportion of the selling price which accrues to the trust, since it gives no weight to the profits realized by the trustee on the differences in computing the creation and offering prices or from the "breakage" or from the long and short positions. As a matter of fact, the percentage of registrant's gross profits from the distribution of these shares amounted to approximately 12 percent for the first 9 months of 1937. Hence, but approximately 88 percent of the investors' funds actually accrued to the trust. In our opinion the statement that 91.8 percent of the investors' funds are estimated to accrue to the trust is materially misleading. The registrant argues that the statement was inadvertently carried over from the prospectus of its predecessor. This contention carries no weight in a stop order proceeding, since we are merely seeking to determine whether the prospectus is deficient in fact and not whether it was purposely made deficient.

Finally, it is alleged and admitted that there is no specific disclosure in the prospectus that the fact that new shares are created on the basis of bid quotations rather than closing sales prices results in a diminution of the equity of existing holders of trust shares. Actually it is true that funds are paid into the trust on the basis of figures which are consistently lower than the prices at which the equity of each existing shareholder in the trust's investments could be dupli-

[2] It is also alleged and admitted that exhibit D omits some of the factors discussed above. We, therefore, find that for the reasons heretofore stated, the exhibit is likewise deficient. The descriptive titles with which registrant has preceded certain of the price computations are particularly confusing and do not give any real notice of the margin of registrant's profits.

[3] In the other 2 prospectuses the percentages are stated to be 90.5 percent and 91.5 percent.

cated. The registrant claims that the diminution is so slight that it is immaterial. It is our opinion that though the dilution is slight it occurs in the case of the creation of each and every share in the trust and should have been disclosed.[4]

Since we have found material deficiencies in the registration statement and in the prospectus, stop orders must issue unless we exercise our discretion to consider the post-effective amendments in this proceeding. The registrant's reasons for asking that we consider these amendments, declare them effective and dismiss these proceedings were summarized at the outset of this opinion. We should further note that according to the post-effective amendments registrant now proposes to forego the profit which resulted from computing the resale price of the shares upon the basis of the closing prices on the previous day's securities markets. On the other hand, registrant does not state that it will desist from trading in the trust shares in connection with their distribution. Although it does propose in the future to buy shares from the trust only prior to the close of the securities markets on the day of purchase, it will nevertheless continue to be in a position to determine with substantial, if not the former precise accuracy what the following day's sale and resale prices will be.

Under the Securities Act of 1933 this Commission is not authorized to prevent the sale of securities to the public merely because the prices of the securities or the profits incident to their distribution may be unreasonable or even extortionate. Nor is the power to issue stop orders dependent upon the Commission's view of the merits or demerits of registered securities. On the contrary, the statute requires no more than full and honest disclosure by the registrant of material information on the basis of which the investor may form his own judgment of the registered securities.[5] Hence, assuming full disclosure of the facts, neither the claimed right of the registrant to trade in the trust shares in a manner adverse to the trust and its shareholders nor its ethics in taking profits at their expense is material to the finding of untrue or misleading representations, or the omission of required information, upon which alone a stop order must be based. But notwithstanding this limitation upon the Commission's power to issue stop orders, section 8 (c) governing the amendments which registrant now asks us to consider does confer a broader duty upon the Commission to permit such amendments to become effective only if apparently accurate and only when consistent with the public interest and the protection of investors.[6]

The discretion here conferred must be exercised so as to afford a real protection to investors through the fullest possible notice of the deficiencies which we have found to exist in this case. The registrant's undertaking to furnish copies of the post-effective amendments, when and if declared effective, and of the amended prospectus to its shareholders would not, in our opinion, be comparable to the notice that would be afforded by stop orders—notice to which the investing public is entitled under the Act. *In the Matter of National Boston Montana Mines Corp.*, 1 S. E. C. 639, 646 (1936). No assurance has been given that copies of the post-effective amendments and the amended prospectus would be furnished to those persons who by reason of their interests in the subordinate investment trusts referred to above, and more fully described in *In the Matter of Income Estates of America, Inc.*,[7] are indirectly owners of the Trusteed Industry Shares held in the portfolios of these subordinate trusts. Since these persons purchased their certificates on the basis of the prospectus involved in this decision and since the security covered by the registration statement here considered constitutes the sole asset underlying their certificates, they are directly concerned with the deficiencies in the statement and prospectus and in the amendments thereto.

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[4] A material deficiency also exists in item 28 as a result of registrant's failure to disclose in answer to that item that it holds and is now exercising an option to buy for its own account outstanding shares tendered to the trustee for liquidation. Item 28 requires a statement of the terms and conditions upon which holders of the trust shares may terminate their interests. Failure to state the practice of buying the shares so tendered for liquidation operated, as it admittedly was intended to do, to prevent the trust assets from showing reductions as a result of shareholders' liquidations. Concomitantly this practice has concealed the actual extent of liquidation by shareholders—information which they would be led to believe from the registration statement would be disclosed in the trust's periodic financial statements.

[5] Compare sec. 32, which provides that "Neither the fact that a registration statement for a security has been filed or is in effect nor the fact that a stop order is not in effect with respect thereto shall be * * * held to mean that the Commission has in any way passed upon the merits of, or given approval to, such security."

See also S. Rept. No. 47, 73d Cong., 1st sess., p. 2: "It has been deemed essential to refrain from placing upon any Federal agency the duty of passing judgment upon the soundness of any security." H. Rept. No. 85, 73d Cong., 1st sess., p. 4.

[6] Section 8 (c) provides: "An amendment filed after the effective date of the registration statement, if such amendment, upon its face, appears to the Commission not to be incomplete or inaccurate in any material respect, shall become effective on such date as the Commission may determine, having due regard to the public interest and the protection of investors."

[7] 2 S. E. C. —; (1937) Securities Act Release No. 1480.

The process of distributing these shares has been and still is a continuous one and, to a great extent, the shares ultimately are paid for by the public in small installments. Hence, inasmuch as registrant has continued to sell shares subsequent to institution of these proceedings, we believe that a declaration of effectiveness of the post-effective amendments and the consequent dismissal of the proceedings without issuance of stop orders would not give to those who are even now buying these shares adequate notice of the character and importance of the deficiencies in these registration statements.

Furthermore, we deem it significant that a stop order has previously been issued against this same registrant on August 2, 1935 (file No. 2-1303, not reported).[8]

In short, it is our view that registrant's failure to disclose the practice of trading in trust shares to the detriment of the trust which it manages and at the cost of its shareholders precludes the exercise of our discretion in favor of the registrant in such a manner as to diminish that full notice of material deficiencies which is given by the issuance of stop orders.

For the foregoing reasons we have determined not to consider the post-effective amendments filed in these proceedings. Cf. *In the Matter of Haddam Distillers Corp.*, 1 S. E. C. 37 (1934);[9] *In the Matter of Income Estates of America, Inc., supra; In the matter of Canusa Gold Mines*, 2 S. E. C. — (1937); Securities Act Release No. 1507.

A stop order will issue in accordance with this opinion.

UNITED STATES OF AMERICA BEFORE THE SECURITIES AND EXCHANGE COMMISSION

AT A REGULAR SESSION OF THE SECURITIES AND EXCHANGE COMMISSION HELD AT ITS OFFICE IN THE CITY OF WASHINGTON, D. C., ON THE 25TH DAY OF FEBRUARY, A. D. 1938

In the Matter of T. I. S. Management Corporation. File Nos. 2-1303, 2-2316, 2-3485

STOP ORDER

This matter coming on to be heard by the Commission on the registration statements of T. I. S. Management Corporation, after confirmed telegraphic notice by the Commission to said registrant that it appears that said registration statements include untrue statements of material facts and omit to state material facts required to be stated therein and omit to state material facts necessary to make the statements therein not misleading; and upon evidence received upon the allegations made in the notice of hearing duly served by the Commission on said registrant, and the Commission having duly considered the matter, and finding that said registration statements include untrue statements of material facts and omit to state material facts required to be stated therein and material facts necessary to make the statements therein not misleading in items 28, 36, and 38, exhibit D, and in the prospectus, all as more fully set forth in the Commission's finding of fact and opinion this day issued, and the Commission being now fully advised in the premises.

It is ordered pursuant to section 8 (d) of the Securities Act of 1938, as amended, that the effectiveness of the registration statements filed by T. I. S. Management Corporation be and the same hereby is suspended.

By direction of the Commission.

[SEAL] FRANCIS P. BRASSOR, *Secretary*.

Mr. BANE. I do not know how long you want me to talk on the technical phases. I would rather answer questions on them, because these are just a few of the more or less technical questions which are little understood by the type of persons to whom the security is sold, but they are practices that have a very, very material effect on what the

[8] Amendments correcting the deficiencies upon which this order was based were declared effective August 9, 1935, pursuant to the last sentence of section 8 (d), and the stop order then ceased to be effective.

[9] We said at page 47 of our opinion in the *Haddam Distillers* case: "Now that the deficiencies have been called forcibly to its attention it hopes by curing them to regain its right to sell securities, but it should certainly not acquire that right under these circumstances when this Commission has the power to transmit generally to the public this evidence of the registrant's disregard of fundamental business ethics. * * * A nation of investors deserves, at least, this slight protection."

average person buys as an investment and into which the man of small means puts his savings.

Senator WAGNER. As far as you know, there is no law to prevent that sort of inside speculation?

Mr. BANE. If you could get him for stealing or larceny, that is the only thing I know of.

Senator WAGNER. There is nothing that the Commission can do under the present law?

Mr. BANE. The only thing we can do is what we did. He failed to disclose in his statement that he had done this and that it had been a practice. We said that it was a material fact which he had not disclosed and we stopped the sales.

Senator WAGNER. There are some that are not registered?

Mr. BANE. There are 650, and only 265 are registered.

Senator WAGNER. They are not required to register?

Mr. BANE. Evidently not. They are exempt under one of the provisions of the Securities Act. Some of them have not filed with us because they are not making any further sales.

Senator WAGNER. You used the word "sponsor." I think I understand what a sponsor is, but nobody has yet used that word in the testimony here. I wish you would explain that.

Mr. BANE. Well, a sponsor is one who originates and looks after the turst. Really, most sponsors are equivalent to the management of the trust.

Senator WAGNER. Not necessarily?

Mr. BANE. But not necessarily. They may sponsor, organize, or promote the trust, and then make a management contract with others, but they very seldom turn that over. They may turn it over under another name, but they still control it.

Senator WAGNER. Of course, underwriters and managements are not the same?

Mr. BANE. In a great many instances—in most instances—they are the same person. In 90 percent of the cases they are.

Senator WAGNER. Theoretically, there is a conflict there?

Mr. BANE. Undoubtedly.

Senator WAGNER. A conflict of interest?

Mr. BANE. Yes, sir; undoubtedly a conflict of interest.

Now, I have not taken any of these others up because I did not know how much time you wanted to spend on them.

I thought I made clear in this last case that the Securities Act of 1933 is a disclosure act. We cannot do anything further. We cannot regulate that practice which I just mentioned. All we can do is compel a disclosure of it, and if he does not disclose it and we find out about it we can prevent his selling. After it is properly disclosed he can continue to sell, and the only effect is the effect that that disclosure may have on the building up of sales resistance.

Senator WAGNER. The other question that I meant to ask had reference to their charters. Some of the charters of the investment trusts are very extensive as to what they may do. There is no limitation that you can impose upon them under the law?

Mr. BANE. Nothing but disclosure.

Senator WAGNER. Outside of the disclosure, you cannot limit their activities, so that they may invest only in certain types of securities or engage in only certain types of business, similar to the regulations

that we have with regard to other financial institutions that use or are entrusted with public money?

Mr. BANE. Under none of the laws that this Commission administrate do they have any regulatory authority over an investment trust.

Senator HUGHES. I want to ask you this. There are 650, I believe, that are registered?

Mr. BANE. No; 650 are still in existence.

Senator HUGHES. And some 247 have registered?

Mr. BANE. Two hundred and sixty-five have registered.

Senator HUGHES. Well, assuming that there are 265, it would be almost impossible for them to regulate themselves, if they were so minded, if they tried as a group, because if some of them did not cooperate and followed these practices, the others in competition with them would not be able to have sales to compete with them?

Mr. BANE. Senator, great minds run in the same channels. I was just getting ready to say that many of the managements of the better investment trusts have admitted the evil effects of these practices that I have been talking about here and have said to me and to others frequently that they would like to get rid of them and, "We will get rid of them if you make everybody else get rid of them. We will heartily join in any movement that will correct it in this industry, but we cannot do it alone and live."

I think I explained that in the two-price system. That is to my mind one of the strongest reasons for this bill. The industry itself—even the better element that want to correct the evils—cannot do it and live if they do not all do it, and you have got to have some legislation of this sort to make them all do it.

I can discuss a few of the stop-order cases, if you will give me an idea of how much longer you will sit.

Senator WAGNER. I do not want to keep Senator Hughes here, because I think he knows more than any of us about the investment trust subject.

Mr. BANE. Would you like me for a few minutes to refer to some stop-order cases—just a few?

Senator WAGNER. Yes.

Mr. BANE. We had one concern file with us to sell shares. I think they were selling shares of common stock. It registered with us. I am going to give you this to show you that looting is not all over.

This concern registered with us and got an effective registration statement. That means that as far as was shown from such an investigation as we could make, they made adequate disclosure. They put in the registration statement what they think they can sell for a year. The Act requires that they file a new prospectus if they continue to sell after 13 months. We asked them about one and we got no reply. We sent an investigator to the headquarters of the company to find out about it. We could not locate anybody. We found that the landlord had impounded everything in the office for back rent.

We went to the trustee or custodian and we found that he had ceased to be such or had handled the funds last some 6 or 7 months ago. We found also from him that he had also turned over, as he had a right to do under the so-called trust agreement, the portfolio of the trust to the officers of the trust, the sponsors of the trust.

Finally some of those officers were located over at 40 Exchange Place, New York, and from there we traced the portfolio into a trading account on Wall Street.

We went into that trading account and found that the entire assets of the trust—I do not remember just the amount, just a small amount; they had been in operation only a short time—$39,000—had been lost in speculating on the market.

We turned this case over, of course, to the legal division.

Senator WAGNER. You mean they just took that money?

Mr. BANE. They just took that money. They came down to us, registered under the Securities Act, obtained an effective registration statement, went out and sold, to the extent of at least $39,000, securities to the public, operating less than a year. Then they took that $39,000, appropriated it to themselves, used it in a trading account on the Street, and lost it all.

That happened since that 1933 Act by a company registered under the 1933 Act, and there was nothing that could have told us that the man was going to take the portfolio.

Senator WAGNER. There is no difference between that and taking the money and playing the races, is there?

Mr. BANE. Sometimes I think you have more chance on the races.

Senator WAGNER. It is more fun.

Mr. BANE. More fun; yes.

Senator WAGNER. What happened in that case?

Mr. BANE. We turned that over to the legal authorities for prosecution. We can do nothing.

We had another case, and this is a small amount. I just want to show you what can be done under this act. I am a great believer in disclosure and publicity, and I think in most situations disclosure and publicity are about all required. I am a believer in the 1933 act and the principle on which it was founded, but there are situations and there are certain types of practices engaged in in certain types of situations that publicity won't correct, and this is one of the types I have in mind.

We had another concern register with us as an investment trust and obtain an effective registration statement. He sold only a small amount of securities—in fact, he sold to but one man, but he sold that one man $3,000 worth, and as I understand the situation, he was able to get the $3,000 out of this cafe operator because he was registered with the Government.

He did not attempt to sell any more, because all he needed was to buy a farm with the $3,000 or erect a house on it and begin selling patent medicine, and that is what he did with the entire assets of the trust.

Those are cases that are small. There have been larger ones registered with us, but those are people who, as far as we could tell, had made an adequate and full disclosure and had gotten an effective registration statement. Nevertheless, to the extent that they had a portfolio, the persons I just referred to took it after they had sold the securities to the public.

We had another concern register with us and it represented in the statement it filed with us and in the prospectus that it would pay dividends only out of profits and in other places used the word "income." It did not define "income" or "profits." It had financial

data which indicated that it used the terms "income" and "profits" in the usual ordinary way.

After the statement had been effective for quite a while—about a year or more—we found that that company was using and had not disclosed a very peculiar formula by which it worked out what it was calling profits and income. It did not by any manner or means account for income and profits in the ordinary sense that a man would use it. The management could so shuffle the assets under their formula as to make a profit any time they wanted to. They would mark up assets and they would reappraise them and revalue them, and they did. They would then take that unrealized or marked-up appreciation and put it into income, and out of that would pay dividends—so-called dividends.

They would pay that because their remuneration depended upon and was a certain percentage of the dividends paid out.

From 1933 to 1938 we found that this particular concern, without disclosing what it was doing, had paid out $851,000 in so-called dividends, when, as a matter of fact, it had been operating during the entire period at a loss, and had taken as commissions on those "dividends," 10 percent, or eighty-five thousand some hundred dollars for itself. It did not disclose——

Senator Hughes (interposing). Was that from the dividends?

Mr. Bane. That was additional, out of the trust. It got as its management fee 10 percent of the amount it paid out in dividends. When we discovered this, we could get a stop order against them, and we did; this Investment Trust Act to a large extent prevents such practices.

Senator Wagner. Did the investors get part of the money back?

Mr. Bane. The investors got part of it back, a return of capital.

Senator Wagner. Did any of the $861,000 represent profits?

Mr. Bane. Not a bit. It had been operating at a loss entirely. The public could not get out as much as it put in. It had taken out its own fees for management and it had been operating at a deficit.

Senator Hughes. The paying of the dividend, of course, was helping to sell their securities and pointing out the fact that they were earning money?

Mr. Bane. It was helping to sell their securities and also giving a return to the sponsors for a management fee.

Senator Wagner. Do you happen to know how those securities were sold and to whom?

Mr. Bane. They were sold, as I described, to the average, small investor as a safe investment for this savings.

Senator Wagner. Were they advertising that?

Mr. Bane. As I remember, when we got into examining the case, there were few persons in the trust who owned more than a $500 interest, so it was sold chiefly to the investor who invested $500 or less.

Senator Wagner. I was wondering about the type of people they were and whether they were solicited.

Mr. Bane. There is one other thing that I might mention, Senator. The peculiarities of accounting in some of these investment trusts—I do not mean all——

Senator Wagner. We all understand that.

Mr. Bane. The peculiarities are something marvelous sometimes, and the peculiarities are dependent in many instances on how the various fess are paid.

This man had a contract and he represented to those to whom he offered the securities, "If you do not profit, I do not profit. My management fee is only on a certain percentage of the income or the dividend." So he had to pay a dividend to get anything. Therefore, he went through all kinds of tricks in accounting in order to get up an income from which he could pay that dividend, and whenever you get the fee of the management in these investment trusts largely dependent or wholly dependent upon either profits, income, or dividends for payment, the methods followed are almost fantastic in order to get something that they may call profit or dividend to pay the "income" in order that they might get that fee.

We make them set the thing up on a proper accounting basis from a disclosure standpoint. We cannot, however, stop them from paying so-called dividends if they want to. We do make them state that that dividend is a return of capital.

Senator WAGNER. A return of capital?

Mr. BANE. A return of capital. We make them show that that so-called dividend is a return of capital to the investor.

Senator HUGHES. Where do they show that? On the check?

Mr. BANE. They show it in the prospectus. We make them say that this dividend constitutes largely a return of capital.

Consider the type of person to whom these securities are offered and sold. What does a return of capital mean to that person? Return of capital to them is just the same as dividends from income. They do not distinguish between them. That is true of some of these holders who are fairly well educated.

I happen to know a young lady who is a college graduate and teaches at high school, and she thought she was getting the equivalent on her trust of a return of income to the extent of 12 percent a year.

We can make them disclose those things, but we cannot prevent them, we cannot regulate them, and we cannot give to the person to whom they make these representations the ability to make them understand.

Senator WAGNER. You said a moment ago that this particular concern paid out $800,000. Was it in dividends?

Mr. BANE. Yes.

Senator WAGNER. Over a period of time?

Mr. BANE. Yes.

Senator WAGNER. Will you tell us about the character of the investments they made during that course of time?

Mr. BANE. Yes; we had that portfolio before us. I know they had some securities, and I am informed by some of the men here who are familiar with it that all of their securities were listed on the New York Stock Exchange or New York Curb. But you will realize, Senator, that some portfolios of listed stocks comprise practically every stock on the exchanges, and the management can use poor judgment, and there are some speculative stocks on the exchanges.

Senator WAGNER. I wondered if any of them went into any actual business ventures.

Mr. BANE. Not in this particular case, but we do have some that do. We had a stop order against a concern that represented to us when it filed that it was going to invest the money that it obtained

from the public in listed securities on the New York Stock Exchange or the New York Curb. After it got the moneys, and it sold something like $100,000 worth of securities, we got information tending to show that they were putting that money not in New York Stock Exchange or the New York Curb listed stocks, but in highly speculative securities, and in one instance were loaning it to an officer of the management and taking his unsecured note in return.

We succeeded in procuring a stop order against him and preventing further sales.

We also found one that had done the same thing—sold them on the basis of investments in the New York Stock Exchange and invested it in timberland in the South.

Senator WAGNER. I think I recall Mr. Schenker referring to one in which $100,000 was used to operate a laundry of some kind.

Mr. BANE. The one that I refer to used to operate timber property, and there was one that I told you about that used it to operate a farm and patent-medicine business. And these investment trusts are very easy to organize.

We had one, somewhat similar to the one mentioned a few moments ago, which represented that it was going to buy securities on the New York Stock Exchange or the New York Curb. Instead we found that it was putting all the funds in another affiliated investment trust, and which second trust I do not think required that its funds be invested in listed securities.

Do you want any more?

Senator WAGNER. They are all very interesting. How many more are there?

Mr. BANE. We have had proceedings under section 8 of the Securities Act, which is the one we issue a stop-order under.

We had proceedings under this section against approximately 43 concerns of the 265 that are registered with us.

We had stop-order proceedings against the Equity Corporation. I do not want to go into it, because I am sure Mr. Schenker is going to cover it in detail and cover the background and history. The Equity Corporation filed with us, and we had a stop-order proceeding against it and its affiliate, Consolidated Funds. Those were two large investment companies, and we commenced stop-order proceedings and as a result thereof they corrected their registration statement to make accurate disclosure.

Senator HUGHES. They are not engaged in business now?

Mr. BANE. They are engaged in business; they are not selling securities.

Mr. SCHENKER. The Equity Corporation is the one which now owns the United Founders Corporation that we were telling you about.

Mr. BANE. I did not want to go into that, because I thought Mr. Schenker was going to handle that. We had a somewhat different concern that we got a stop order against. It was one of those installment-plan companies. You deposit $10 a month with it and it would buy shares in another trust as its underlying portfolio. You deposited $10 a month for 10 years, 120 payments, and instead of

what its actual charter showed you—that is, that you got at the end of those 10 years whatever your proportionate share of the underlying portfolio was—they were telling the purchaser that he had a $2,000-face-amount contract, that is,

> If you deposit this $1,200 with us, $10 for 120 months, we will give you at the end of that time $2,000,

whereas the actual obligation was only to give you, in their contract, your proportionate share of what that underlying portfolio was, and the only way to get $2,000 was for another trust to come in and enhance to the $2,000, the amount you invested, less deductions.

We had another one file with us—to show how fantastic some of these are—where he actually offered to the public—said so in the literature, upon the deposit by the purchaser of $25 a month for 10 years, at the end of another 10-year period they would pay him $42,000.

We took the stocks in which he said he intended to invest—the portfolio—and we examined those and we found that the maximum annual return that could be expected from those was 3½ percent, and we could not figure out how $25 a month deposited for 10 years could possibly be built up to $42,000 in that time.

Senator WAGNER. I suppose some of the sponsors said that the Government was interfering with their business?

Mr. BANE. I have heard the complaint once or twice, Senator.

Senator WAGNER. Have you any other questions?

Senator HUGHES. No, I think not. Senator, you have intimated that I have unusual knowledge of ways that are dark.

Senator WAGNER. No, but in my discussions with you I know that you know some of these methods that have been used.

Now, there are some witnesses who are yet to appear either in opposition or to explain or make suggestions in regard to this bill, and we would like to have some idea of the amount of additional time the Commission will take.

Mr. HEALY. I would like to have an opportunity to discuss that with my brother commissioners in the morning or afternoon. I can say this: The decision is not a very easy one from our point of view. We are very anxious not to give the Congress the impression that we are just fooling around with a few isolated instances of fellows who have looted and stolen trusts.

We have a great deal of these instances that we can describe, and what perhaps may be more important, we can describe the economic problems that grow out of situations where actual dishonesty is not involved.

Senator WAGNER. I do not think we have had any testimony which you could characterize as insignificant. My impression is that it has been just the opposite.

Mr. HEALY. A good deal depends on how much the committee wants to hear.

Senator WAGNER. Well, we want a complete picture of this whole problem. You have been living with this subject for some years and we are getting it now for the first time. We want to absorb it, and it takes a little time. You must be a little patient with us. When you take one company on top of another, it is very difficult to follow you.

However, I do want to have some idea as to how many are going to appear after the Securities and Exchange Commission witnesses and when they may be expected to be heard. We want to have a complete picture and have everybody who has an interest given a chance to be heard. Yet we cannot be here interminably because I am hoping that the committee will act upon the legislation very soon after the hearing is closed.

Mr. HEALY. Do you want to hear any of the witnesses from the Commission discuss the specific provisions of the bill before you hear the industry?

Senator WAGNER. I think we ought to have that, too.

Mr. HEALY. I think it might be fairer to the industry if they had a chance to meet the suggestions that we have.

Senator HUGHES. I presume that there are persons engaged in the industry, as you call it, present or will be present, and they could hear your explanations, and then, when they see fit to testify, they can do so.

Mr. HEALY. Very well. May I get in touch with your office in the morning, Senator, to try to arrange a program?

Senator WAGNER. (chairman of the subcommittee). Yes. At any rate, we will resume the hearing on Monday at 10:30. Whom do you expect to be here?

Mr. SCHENKER. We will give you the list at the time we communicate with your office.

(Thereupon at 1:05 p. m. an adjournment was taken until Monday, April 8, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

MONDAY, APRIL 8, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on Friday, April 5, 1940, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), and Downey.

Senator Wagner. The subcommittee will proceed. There will be other members of the subcommittee present a little later on, I am sure. We must have conversation in the room stopped. It is not fair to witnesses or to members of the subcommittee to have conversations going on in the room.

Judge Healy, would you like to make a statement?

Mr. Healy. Yes, Mr. Chairman.

Senator Wagner. You may proceed.

STATEMENT OF ROBERT E. HEALY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.—Resumed

Mr. Healy. Mr. Chairman, at the close of the testimony last Friday I requested permission to consult with the other Commissioners before attempting to reply to your inquiry as to what further testimony the Commission thought it necessary to submit. In view of the chairman's suggestions, we propose to offer this morning a very brief discussion of those companies which sell investment trust securities to small investors on the installment or periodic-payment basis.

The Commission feels that after the completion of that testimony there will have been presented to the subcommittee a fairly comprehensive picture of the investment-trust industry and its characteristics. Although the picture has necessarily been limited to a very brief outline, it should be possible to fill in many details in the course of the discussion of the specific provisions of the bill.

Accordingly we would like to begin, later this morning, an exposition of the bill, section by section. I wish to make it clear that moving to the discussion of the bill at this time does not mean that we have run out of material. Our principal embarrassment thus far has been due to the difficulty of deciding what material to select from the large amount available. For the complete picture, of course, we must refer the subcommittee to the full report of the investment-trust study.

If it is agreeable to the Subcommittee, Mr. Boland of our staff will take up the investment-trust companies that sell their securities to small investors on the installment or periodic-payment basis.

Senator WAGNER. Very well. You may proceed, Mr. Boland.

Keep your voice up, please.

STATEMENT OF JOHN BOLAND, ATTORNEY WITH THE GENERAL COUNSEL'S OFFICE, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. BOLAND. Mr. Chairman, the periodic-payment plan certificates are really tripartite contracts between the sponsor or distributing company, the trustee, which is generally a large financial institution, and the subscriber, under which the subscriber is called upon to make certain monthly installment payments over a period generally running for 10 years.

These monthly payments have ranged as low as $5 a month and as high as $200 a month. However, our survey shows that the most widely distributed plan was one which called for payments of $10 per month.

As a rule the subscriber makes his payments directly to the trustee, which deducts its own fee and the service charges of the sponsor company, and then applies the balance of the payments to the purchase of shares in a regular fixed type or management-type of investment trust.

In the purchase of these underlying shares there is an additional sales load, ranging from 5 percent to 9½ percent, which must be paid by the subscriber. In more simple terms, the periodic-payment plan is one trust superimposed upon another trust, with two trustees and two sponsoring companies. You can see, therefore, that the investor must pay two sets of trustees' fees and two sets of service charges or sales loads, and——

Senator WAGNER (interposing). Will you explain that in a little more detail, as to what you mean? Please explain how a trust is superimposed upon another trust. Whose property does the particular certificate that has been purchased, or share, represent? Is it the first trust, the second trust, or both, or how is that done?

Mr. BOLAND. If you please, Mr. Chairman, the top trust is really the periodic-payment-plan certificate which is created by the sponsor company. The periodic-payment-plan certificate subscriber pays into the trustee of the top trust these monthly payments. After the top trust trustee makes these deductions for its fee and the fee of the top trust sponsor company, the balance is used to purchase shares in an underlying trust. The underlying trust is a regular investment trust of the fixed type or the management type. So that all that the contract holder in the top trust gets is an equity in the underlying trust.

Senator WAGNER. What I would liked to know is this: Is there any public interest reason for two trusts of that character; is there some special protection to the investor in the creation of two trusts, one a fixed-type trust and the other a top trust?

Mr. BOLAND. These periodic payment plans originated early in 1930, when the investing public was undergoing its most tragic experience in overspeculation, and were designed to contact the very

small wage earner as a means whereby he could save $5 or $10 a month, and it was represented that through this medium of investment he could build up an estate over a period of 10 years.

I will illustrate that if I may, and in order to do so I should like to read an excerpt from——

Senator WAGNER (interposing). Why were both trusts in that plan? Why was there any need for a top trust and also this other—what did you call it, an underlying trust?

Mr. BOLAND. The top trust is really the contractor through which the subscriber agrees to pay for so many shares each month, and then——

Senator WAGNER (interposing). I understand that, but is it a device or is it an additional protection to the investor, or why do they need this method of going through one trust and all that sort of thing when the top trust itself is to handle it, the operation of it, and is to purchase an interest somewhere else.

Mr. BOLAND. When the underlying investment shares are available for less than $10 a share, then the subscriber can purchase directly underlying shares without paying the service charges of the top trust company.

Senator WAGNER. Which is the load you are talking about for that service?

Mr. BOLAND. Yes, sir.

Senator WAGNER. Why is it there? Is it just in order to earn that fee or what is it?

Mr. BOLAND. Well, Mr. Chairman, I am not in position to base any conclusions as to the economic utility of this type of trust companies. All I know is that they have been in existence, and they have placed a tremendous cost upon the investor to use the medium in the way of investment in investment-trust shares.

Senator WAGNER. Which really is merely a sort of agent for the purchaser of an interest in the fixed-type trust?

Mr. BOLAND. It is really the agent, or a scheme by which the investor feels obligated to pay so much each month. If it were not for this top trust contract the proponents of the periodic-payment plan claim the investor would not make regular payments. So that is really one justification for it according to the proponents of the plan. It is a means of compulsory saving.

Senator WAGNER. It is not clear to me yet, but you may proceed with your statement. I mean that I understand what you say, but as to the necessity of the plan, I do not understand that.

Senator DOWNEY. Mr. Chairman, might I interpose a question right there?

Senator WAGNER. Certainly, Senator Downey.

Senator DOWNEY. Is the top trustee virtually a selling agency for the organization?

Mr. BOLAND. Invariably it is the selling agency.

Senator DOWNEY. You can easily enough see, Mr. Chairman, why that can be advantageous from the viewpoint of the promoter.

Senator WAGNER. Perhaps so, but I am thinking of the public. Is there anything in it to protect the investor?

Mr. BOLAND. My own personal opinion is that the economic need is very doubtful.

Senator WAGNER. Very well. You may go ahead with your statement, Mr. Boland.

Mr. Boland. The double load or service charges which a subscriber to one of these plans subjects himself in very many cases amounted to more than 20 percent of the total amount which was invested for his account. In a number of instances the underlying trust of the sponsor company charged in addition to the sales load on its sales, a management fee. In those cases the management fee brought that percentage up to as high as 25 percent of the total amount which was invested for the subscriber's account.

Senator Wagner. Is that just paid once, or is it paid as each installment is paid? As I understand the situation described, they are installments over a period of time.

Mr. Boland. Yes, sir.

Senator Wagner. Is there a fee paid for each transaction, or is the fee paid upon the making of the original contract?

Mr. Boland. It would depend upon the particular charge that is being made. For example, the sponsor company of the certificate, or the top trust, takes its service fee out of the first 10 or 12 payments. The load on the underlying shares is paid as the underlying shares are purchased for the subscriber's account; so that that load continues over the life of the plan as the shares are acquired each month.

The management fee, where there is one, is generally taken out of the gross proceeds of the underlying trust, out of revenues, earnings or dividends, on the portfolio of the underlying trust. This management fee generally is set forth at one-half of 1 percent of the daily average value of the underlying portfolio.

Senator Wagner. But if it is reduced there is no charge, no management fee, is there?

Mr. Boland. If the revenues of the underlying trust are nil then the sponsor company does not receive any management fee.

Senator Wagner. But if not nil but reduced, say, by 1 or 2 percent of its value?

Mr. Boland. If the portfolio comes down in market value then the management fee is proportionately reduced.

Senator Wagner. Still there is a management fee, is there not?

Mr. Boland. Yes, sir.

Senator Wagner. All right. I thank you. I will try not to interrupt you any more.

Mr. Boland. Please do interrupt me if I do not make myself clear.

Senator Wagner. All right.

Mr. Boland. I should now like to read from this pamphlet, because it illustrates very clearly the manner in which this type of investment was held out to the small-wage earner. I am reading an excerpt from a pamphlet which was given by one of the distributing companies to its salesmen for use in their distribution plan:

> What will the F. I. F. plan do for me?

And I might explain that the F. I. F. represents Financial Independence Founders. I continue quoting:

> It will help you—

Senator Wagner (interposing). Is that one of the group testified about on Friday or is that another company? It is not the Founders group, is it?

Mr. Boland. No, sir. This is the periodic-payment plan strictly.

Senator Wagner. All right.

Mr. BOLAND. I will continue reading:

It will help you—

To create an old-age retirement fund.

To provide a fund for educating your children.

To buy a home or pay off a mortgage.

To raise capital with which to go into business.

To create a business reserve.

To travel and enjoy the comforts and luxuries only money will buy.

Your great need is to make the setting aside of a certain portion of your income automatic each month.

"A part of all you earn is yours to keep."

Therefore, when you adopt a definite plan to set aside regularly a certain portion of your income in a trust fund, such a plan helps you to convert good intentions into solid financial accomplishments. The Financial Independence Founders plan provides a method whereby it is possible for you to create a fund of sufficient size for you to become actually financially independent. So many other methods for accumulating money offer such low rates of return that it is almost impossible for a person of average earning power to set aside a large enough portion of his earnings during his productive years to build up a capital fund of sufficient size to enable him to live on the income.

Bear in mind that, in America, practically all fortunes are built from the ownership of successful businesses.

The Financial Independence Founders plan makes it possible for you to obtain the same diversified ownership of successful businesses as the man of large means, thus giving you the same opportunity to profit from dividends and from the growth of leading American industries.

From about 1930 to 1936—

Senator WAGNER (interposing). When was this pamphlet issued?

Mr. BOLAND. This pamphlet I believe was used right up through 1938. During the period 1930 to 1936 these periodic-payment plans were distributing in 45 States, in Panama, in Puerto Rico, and in the District of Columbia. During that period the contracts outstanding called for payments amounting to more than $154,000,000. During the period up to 1937 subscribers had paid in approximately $55,-000,000.

Senator WAGNER. What period is that?

Mr. BOLAND. From 1930 through 1937.

Senator WAGNER. And you say $55,000,000 were paid in?

Mr. BOLAND. Yes, sir. Our survey showed that at the end of 1937 the equity which the subscribers acquired through the payment of the $55,000,000 had a market value of only $25,000,000. The shrinkage after considering repayments, amounted to $17,000,000, or over 30 percent, was largely due to the service charges, trustees' fees, and sales loads which were deducted from the subscribers' payments. Our examination indicated that of the $17,000,000, over $11,000,000 in the shrinkage was due to such charges.

Of course these figures are exclusive of the face-amount certificates under which the company obligates itself to pay a fixed sum of money to the subscriber at the end of the period of investment. I might say that Mr. Mathews last week pointed out the regrettable theory upon which the face-amount certificates are issued, and it is regrettable for any company to engage in a business which is predicated upon the primary assumption that a substantial number of people who invest in it, must lose all or the most of their money.

Senator WAGNER. Do you think that is a fair assumption?

Mr. BOLAND. I believe Mr. Mathews pointed that out rather clearly last Friday, Mr. Chairman, when he pointed out that the sales overhead and maintenance costs on these face-amount certificate

companies almost consumed entirely the dividends or revenues from the underlying portfolios; so that the only way in which these face-amount certificate companies can make good on their guarantees to pay the subscriber a fixed amount at the end of the period of investment, is by realizing income from another source. The only other source conceivable is through lapses and defaults of a vast number of their subscribers. The thing certain in these face-amount certificates is that if a subscriber defaults within the first 2 or 3 years he forfeits all payments theretofore made.

These periodic-payment plans are different from the face-amount certificate plans inasmuch as the issuer of the periodic-payment plan is obligated in no way to pay to the subscriber anything. All the subscriber to this type of plan is entitled to is the value of the underlying trust shares which are purchased for his account. The value of the subscriber's equity will naturally vary with the fluctuating stock-market prices of the underlying common stocks.

Senator WAGNER. Is there any limitation in law anywhere upon the type of investment that these corporations may make?

Mr. BOLAND. None that I know of.

Senator WAGNER. In other words, so far as their authority goes?

Mr. BOLAND. It is limited only to the terms of the trust indentures which are adopted.

Senator WAGNER. Yes. Do the trust indentures set forth the loads or the payments to be made to the top trusts?

Mr. BOLAND. Yes, sir.

In November 1937 several complaints were presented to the Securities and Exchange Commission which indicates that the fraud provisions of the Securities Act of 1933 had been violated by a number of companies issuing the periodic-payment plans. Accordingly, the Commission directed that an investigation be made into the sales practices and sales methods in which the companies had indulged.

Our investigation revealed that less than 5 percent of the hundreds of subscribers who were examined really had any idea as to the nature of their investment. The investigation also demonstrated that the vast majority of plan-holders had been induced to buy their plans by gross misrepresentations in material facts.

Senator WAGNER. Did it disclose that any of them read this—what do you call that?

Mr. BOLAND. This is a brochure, or sales pamphlet.

Senator WAGNER. Brochure.

Mr. BOLAND. Investigation revealed that very often these pamphlets were handed to subscribers, but in the majority of cases we found the salesman would not hand the subscriber anything except sales talk.

It was repeatedly suggested to salesmen during the course of their training that to hand an investor anything during the course of the sales presentation would interrupt the sales talk; therefore, be very careful, the salesmen were instructed, when handing things to prospects while the sales talk was going on.

Senator WAGNER. Could you tell us, just briefly, what type of people they were? Were they wage earners?

Mr. BOLAND. They were truck drivers, W. P. A. workers, butchers, and people in the smallest income bracket.

Senator WAGNER. How many of the typical holders were there? What was the number of certificates in this amount of $55,000,000?

Mr. BOLAND. I do not have any accurate figure, Mr. Chairman, on the number of subscribers who have purchased these plans, but I should say that they go well above 100,000.

Senator WAGNER. All right.

Mr. BOLAND. And I am just advised by my associate that that was at the end of 1935, and from my own personal knowlege of the momentum which these companies gathered in 1936, 1937, and 1938, they tripled during those 3 years the sales which had been made prior to 1935, so it would be conservative, with those figures, to say that the subscribers are well above 300,000 at the present time.

Senator WAGNER. Are you going to tell us something about the experience had with those companies or that situation now?

Mr. BOLAND. I should like to, Mr. Chairman. Would you care to have me do that now?

Senator WAGNER. No; you go ahead in your own way. I am just curious about it. I really want you to go on in your own way.

Mr. BOLAND. Please interrupt me if I do not make myself clear.

It became more and more clear to us, while we were investigating these companies, and it was my pleasure to assist in the investigation, that high-pressure suggestions and misrepresentations were established. Every day salesmen were given bulletins which were designed to dynamite sales resistance.

With your permission, I should like to read excerpts from a few of them, to illustrate the manner in which the salesmen were instructed to sell these plans. This bulletin is entitled, "The Child Appeal." It reads:

> An analysis of the business on our books today indicates that the most effective single appeal used in obtaining that business was the welfare of children, and since it has been clearly demonstrated that this emotional appeal actually produces contracts, it would be well to ask yourself whether or not you are making full use of it on your prospects. One argument along this line runs as follows: What your children's opportunity is to be, what your children are to be, are questions in the background of every parent's mind. You obviously cannot read the answers in the future, and while you cannot save them from many of the trials of life, you would, I am sure, like to provide them with a good opportunity.

Then, in appendix D of the investment trust study report, in the back of this report, you will find another bulletin captioned, "On Selling Women."

Reading the first paragraph:

> From the cradle to the grave you have sold, and will continue to sell, women. Man, by his very nature, is continually asking of and receiving from women. Unconsciously each of us builds for himself his own especial technique in dealing with the opposite sex. It is with this thought in mind that this memorandum is prepared. I am suggesting that we can each consciously improve that technique, each in our own way, and increase our sales potential through a more intensive drive for women clients.

Skipping down to the paragraph at the bottom of the page:

> Volumes have been written, and additional volumes could be written, on feminine psychology. I offer here, but a few pointers and suggestions which may be helpful. Women are definitely harder to "get to" than the average businessman. The average businessman type of client cannot always devote enough time and attention for a clear explanation of the advantages of Independence Fund for Him. Women, on the other hand, particularly women at home, are definitely harder to see, but once seen they can devote the time and attention that your presentation warrants,

and so on and so forth.

Senator WAGNER. Were there any qualifications of the salesman, as to what type he was to be physically and otherwise?

Mr. BOLAND. I suppose that entered into it. I should like to read the last paragraph of that sales bulletin, with your permission:

While you will encounter procrastination, the desire to consult the family or the friend of the family, the banker or lawyer, it is often possible to speed the closing by the use of direct, firm, quiet pressure. Leaving no question unanswered, but bringing a client again and again to the closing point will definitely accomplish your purpose. There is more truth than poetry in the saying that "A woman's no, means maybe; and a woman's maybe, means yes."

Senator WAGNER. Was what you are reading distributed among the salesmen as part of their instructions?

Mr. BOLAND. That was just a sales bulletin which the salesmen received every day from their sponsor companies, giving them ideas as to how to high pressure clients or prospects.

Going back to the service charges, it was amazing to discover in our investigation that the most commonly used misrepresentation was the statement that a subscriber could get back all of his money at any time.

This misrepresentation was generally supplemented by the further statement that the plan operated like a savings bank account, in which the deposits were 100 percent liquid at all times.

These misrepresentations were viciously misleading inasmuch as the salesman never disclosed the service charge of the top trust company or the sales loads of the bottom trust or the trustee's fees in between, and never disclosed the more important fact that the top trust service charge came out of the first 10 or 12 payments.

I have here one or two letters which indicate the surprise of the average investor upon first learning of these service charges.

With your permission, I should like to read one or two of them into the record.

This is a letter addressed to the Securities and Exchange Commission, dated June 21, 1938:

GENTLEMEN: On February 17, 1937, I purchased five units of Capital Savings, Inc., stock——

giving you an indication that the investor does not understand the transaction—

I returned the certificate to them for refund and they mailed me the enclosed two checks as the full refund due me. It is unbelievable to me that I am compelled to take a loss of this kind legitimately. I paid him an initial payment of $150 and was promised the return of my money at any time I wanted it. I have been unable to get any satisfaction from the said company, and I, therefore, feel that I should put this matter in your hands to see that justice is done me.

He received back $25.

Senator WAGNER. Out of the $150?

Mr. BOLAND. That is right.

The next letter is dated September 6, 1939——

Senator WAGNER (interposing). Well, did he hold an interest after the $25 was returned?

Mr. BOLAND. He apparently decided to withdraw from the plan after he had put in $150.

Senator WAGNER. Yes. Continue your explanation.

Mr. BOLAND. That was one of the features of this plan which very often misled salesmen, because in the sales literature it was indicated that the subscriber could withdraw from the plan at any time. He

could withdraw, but all he could get back was the value of the underlying shares in his account, which amounted to virtually nothing during the first 7 or 8 months.

Senator WAGNER. Was the obligation of this trust discharged by the payment of the $25? Was that the result of the transaction?

Mr. BOLAND. Yes.

Senator WAGNER. In other words, he lost $125?

Mr. BOLAND. That is right, sir.

Senator WAGNER. I see.

Mr. BOLAND. I have here another letter, dated September 6, 1939, addressed to the Commission:

> Would you have time to investigate an outfit that thrives not on gamblers' money but on the savings of ignorant yokels like me who desire to save for the rainy days? I gave these people $150 February 26, 1938, under a plan to invest $75 quarterly. I grew suspicious and put no more money in. A while ago I tried to cash in the certificate and was referred to the wording of the contract, according to which I would have to put in $300 before any adjustment could be considered.
>
> Yesterday I received the enclosed, which you will note is a form letter, indicating that others than I are being lawfully robbed of their first payments when unable to continue, as a matter of simple routine.

In this case the author of this letter received back about the same as the person who wrote the last letter I read.

Senator WAGNER. Is that what Mr. Mathews referred to as the only way you could make this sort of enterprise pay—by the lapses?

Mr. BOLAND. Well, there is a difference in the periodic payment-plan certificates, Mr. Chairman. The sponsor companies for the groups running these things really do not realize any profit by the lapse of these certificates, inasmuch as the companies are not obligated to pay anything to the subscriber. It is only in the face-amount certificates that the sponsor company profits by the lapse or default in payments.

Another very common device which the companies used in the distribution of their certificates was the use of a table which reflected hypothetical projections of their plans over various 10-year periods in the past. These tables were designed to demonstrate that if the plans had been in existence for the past 25 years, then the average $10-per-month plan would have been worth over $2,000 at the end of 10 years.

In spite of the inadequacy of these tables and further in spite of the unpredictability of common stocks, or the future prices of common stocks, these tables were used to demonstrate to subscribers that every $10 monthly plan was almost guaranteed to be worth $2,000 at the end of 10 years. In fact, most of the companies have in the past printed these hypothetical values conspicuously on the back of their certificates. They call them maturity values.

I have here a typical sales talk given by one of the companies to its salesmen, which portrays the manner in which these maturity values were used in the distribution of the certificates:

> Now there are two ways to set up an account: One is by a lump sum deposit. (Write these figures out, down below the bank picture you have drawn.) From $500 to $500,000 or more. The other way and the most common is the monthly deposit plan from $10 to $10,000 or more. It works this way—you start paying, let us say $10 a month and every month. In no event do you deposit more than $1,200, i. e., 120 months at $10. Now there is a definite maturity value and you cease deposits. The bank will send you a check at once. The records show that going back for 25 years or more, that it has only taken an average of 9 years and 1 month for an account to mature. For the past 15 years

approximately 8 years. Please bear in mind, Mr. Prospect, that this is your opportunity and this is your money. If you miss a deposit, there is no penalty or forfeiture. You have complete control of your trust funds at all times. The plan works this way:

$10 per month account mature at	$2,000
$15 per month account mature at	3,000
$20 per month account mature at	4,000

and so on.

To illustrate the misleading effect of these maturity values, I should like to read a letter which we found in the files of one of the companies sent in by a salesman, which indicates that even the salesmen were misled by it. It is a letter dated October 1, 1937, addressed to the Pennsylvania Co. [reading]:

I am the local agent for the F. I. F., and I understand you are the trustee. Recently I sold a contract to one D. R. Benson of Sparta with a $2,000 maturity value.

He wrote your office asking if the $2,000 maturity value meant $2,000 in cash, and the answer came back, "There is no guarantee as to the values of these accounts at any time, by any one."

Just what does this mean? This is a quotation from a letter written by R. M. Brandriff, September 27, 1937.

If this doesn't mean $2,000 in cash at maturity why is the dollar sign used?

The application states that the trustee will guarantee maturity of the contract, if the founder makes regular payments. What does that clause mean?

Here is a salesman who was authorized to go out and sell these things to truck drivers and people of that caliber.

Another artifice which was commonly employed by salesmen was that of harping on the financial resources of the trustees.

The trustee generally—invariabily, I might say—would be a large financial institution, and they would show a prospect the most recent balance sheet of these banks and then would tell the subscriber that the trustee was back of and sponsored the plan. In this way the subscribers got the idea that these large financial institutions actually guaranteed the successful operation of the plan and actually guaranteed the so-called maturity value, whereas, in fact, the trustee is responsible in no way for the operation of the plan, and is not responsible at all except in case of gross negligence and willful misconduct.

In passing, I might say that I hesitate to think of the headaches that these banks are going to suffer in the next few years when people start trucking in by the hundreds demanding their maturity values.

During our investigation the most vicious practice we discovered was that of reloading prospects with additional plans. A very clear illustration of this is shown by an affidavit which we took from a minister in Massachusetts. It seems that the salesman of this plan ingratiated himself into the confidence of the minister by holding himself out as a prospective convert into the minister's faith. After gaining the minister's confidence he induced him to take out a plan calling for $85 a month, on the clear misrepresentation that the minister could get his money back at any time.

After the minister had paid in $2,000 there was a 7½ percent service charge taken out, 7½ percent amounting to $765 on this $85 monthly plan. After the minister had put in the $2,000 the salesman called on him again and told him that he would be much better off if he canceled his original contract and took out a new one calling for $200 a month.

Senator WAGNER. Calling for $200 a month at some later period?

Mr. BOLAND. No; starting as of that date with $200 a month.

Senator WAGNER. He was to get that income?

Mr. BOLAND. No; he was to pay that in under his new contract. He had been paying $85 a month and now under this new contract he would be required to pay $200 a month.

Senator WAGNER. What was the contract? He was to pay $200 a month and what was he to get?

Mr. BOLAND. He was to pay $200 a month for a period of 10 years, and the consideration by the sponsor company and the other parties to the contract consisted of (*a*) the trustee would invest these payments in trust shares for the subscriber's account. The consideration given by the sponsor company was that at the end of 10 years if the subscriber cared to withdraw, the sponsor company would see that the subscriber got back only the value of the underlying shares. It is difficult to point out precisely what consideration is given by the other parties to the contract to the subscriber.

Senator WAGNER. What were the representations? The minister must have had something in prospect to make these payments every month. What did he look forward to?

Mr. BOLAND. Oh, he looked forward, if you please, to the so-called "maturity values."

Senator WAGNER. Were there any prognostications made as to what they might amount to?

Mr. BOLAND. Oh, invariably, the subscriber was told that if he would pay in $10 a month he would get back $2,000. If he put in $100 he would get back $20,000. If he put in $200 a month he would get back $400,000 at the end of 10 years.

Senator WAGNER. $400,000?

Mr. BOLAND. Forty thousand; I beg your pardon.

Senator WAGNER. How much of a return was that? I cannot figure that out.

Mr. BOLAND. It amounts, Mr. Chairman, to about 11 or 12 percent a year return.

Well, at any rate, when he subscribed to this $200-a-month contract he told the salesman that it would be impossible for him to make the $200 monthly payments, and the salesman assured him that it would not be necessary to make these payments every month. So he signed, thereby subjecting himself to another service charge of $1,800 on the new contract.

Therefore, adding the $1,800 service charge of the new contract to the $765, which was the service charge deducted under the old contract, we find now, after paying in $2,000, the minister actually owed the company $565.

Of course, he could withdraw at any time, and he was not bound to make this payment of $565, but if he continued to make his monthly payments of $200 under the contract, the sponsor company or trustee would deduct the $565 from those subsequent payments.

Senator WAGNER. What happened in that case?

Mr. BOLAND. My recollection is that after the Commission instituted proceedings to enjoin this company they apparently discovered that we had obtained this affidavit from him, so they made full restitution to him.

In summary, our investigation revealed that the gospel of this industry from 1930 to 1938 was just sell, sell, sell. Salesmen were given titles and overriding commissions for getting more salesmen in, and branch offices advertised widely in newspapers for more and more salesmen. One company, just operating in Pennsylvania alone, during the 5 years of its existence hired more than 1,200 salesmen, with a turn-over of more than 100 percent. We do not know the actual number of salesmen who had been employed in this industry, but it is conservative, in my opinion, to say that they amount to tens of thousands.

It was a very favorite pastime for salesmen to split their commissions with policemen, foremen on the jobs, employers, and even ministers, for aiding them in breaking down sales resistance. With deference to the ministers, the industry referred to these people as "bird dogs," because they brushed out the prospects for the salesmen, and then the salesmen would be present at the kill.

Many of the misrepresentations which were used in the selling of these plans were due to the psuedo salesmen, principally because the part-time salesman had a complete misunderstanding of the periodic payment plan, and the same thing can be said about a number of full-time salesmen, as indicated by the letter which I read a few minutes ago.

At the completion of our investigation we presented all of these facts to the Commission. The Commission recognized at once the need for immediate action. They also recognized that the problem involved one much deeper than just ordinary sales practices, so they invited representatives of the companies investigated to Washington to attend a conference on April 15, 1938, for the purpose of discussing ways and means of correcting the abuses.

Every one at this conference agreed that the substantial and extensive charges under the plans and the indigent subscribers were the heart of the problem. They all admitted that if these charges were reduced and spread over a greater period of years there would be less incentive on the part of the salesmen to conceal them from subscribers. The conference concluded with the understanding that all of the companies represented at the conference would take immediate steps to prevent the recurrence of the abuses and would forthwith submit plans of readjustment to the Commission, reducing the sales load, spreading the service charge, and so forth.

Within the next 3 months all of these plan companies submitted readjustment programs. Not one of them went far enough; as a matter of fact, most of them merely changed the load from the top company down to the bottom company, or vice versa, and there was really no material change in the service charges except as a matter of form.

Thereupon the Commission decided to make a spot check of the sales practices in which these companies had indulged during the interim period. The investigation showed that the same old abuses, the same old misrepresentations, continued just as flagrantly as before the conference, so that the Commission was left with no alternative but to institute proceedings to enjoin all of these companies which had been investigated.

Up to January 8 of this year the Commission had enjoined eight of the larger companies in the East, and there is a proceeding against the ninth company on the west coast, against Time Trust, Inc.

At this point I would like to read the names of these companies to you, just to show that even the names had misleading effect.

Senator WAGNER. Are these the companies that had been enjoined?

Mr. BOLAND. Yes. Benjamin Franklin Foundation; Wellington Foundation; Capital Savings Plan; Lexington Foundation; United Endowment Foundation; Income Estates of America; Financial Independence Founders.

There are still over 30 periodic-payment-plan companies which are operating which are not subject to these legal restraints.

I would also like to point out that these injunctions do not put these defendant companies out of business; they merely prevent them from further violating the fraud provisions of the Securities Act.

In other words, they enjoin them from doing something which is already unlawful.

In the light of that fact, together with the additional facts of our experience during the months of April, May, and June of 1938, it would be folly to depend on these injunctions alone as the real corrective methods.

Senator WAGNER. Can you approximate the amount of money that has been received by these companies as a result of their sales of this type of securities?

Mr. BOLAND. Net profits, you mean?

Senator WAGNER. No; the amount of money that was paid into these different companies that you mentioned as a result of sales of their securities, whether they were shares, certificates, or what not.

Mr. BOLAND. By the end of 1937 all of the subscribers had paid in approximately $55,000,000 in all of the plans. In these particular plans which have been enjoined I should say the amount of money invested would approximate $20,000,000. They are really the larger companies operating out of the East.

So that in conclusion, Mr. Chairman, since the powers of the Commission under the statutes now being administrated by it merely provide a penalty after the subscriber is defrauded, and since our experience shows that even that penalty is not sufficient to prevent the fraud that has been perpetrated in the distribution of these plans, what the industry really needs is a prophylactic such as this bill provides, to remove the practices by which that fraud in the past has been impelled.

Mr. Chairman, I am just advised by the Director of the Registration Division that a number of these companies have recently filed revised plans, which more or less incorporate the suggestions which were made at our conference with the industry in April 1938. I understand that in these revised plans they have reduced their total loads down to 10 percent, which is a substantial reduction from 25 percent, which had previously been the case.

Senator WAGNER. May I ask a question on that point? You say they filed these revised plans. Suppose they disobey them or modify them themselves, without further notice to the Commission. Suppose they make the load 14 or 15 percent. What can you do about it?

Mr. Boland. We cannot do a thing about it. They can file a revised plan with us again making it 25 percent. If they made a full disclosure we can do nothing.

Mr. HEALY. I think that is true. At the same time I think it is fair to give that branch of the industry credit for voluntarily doing what they could in the direction of changing that. I think the recital of these things happening in the past and the fact that we had to resort to injunctions, which I think has a distinct bearing on the necessity of regulation, I do not think ought to obscure the fact that in these conferences with the industry they have tried to cooperate and achieve some improvement in their practices.

Senator WAGNER. Yes. I asked the question not to intimate that any of those companies changed their plans, but to find out what the state of the law is. That is what I had in mind.

Thank you, Mr. Boland. I believe Mr. Bane is next.

Mr. SCHENKER. Do you mind taking me now instead of Mr. Bane?

Senator WAGNER. You have your choice as to the order of the appearance of witnesses.

FURTHER STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, SECURITIES AND EXCHANGE COMMISSION INVESTMENT TRUST STUDY, WASHINGTON, D. C.

Mr. SCHENKER. If I may say just one word on the installment plans, and we will discuss those a little more in detail when we come to that portion of the bill which relates to that type of investment company, their problem in some respects is not unlike the problem of other investment companies which have to continuously sell their securities, and one of the fundamental problems that this bill deals with is the whole problem of distribution of investment company securities.

To my mind one of the fundamental problems in the investment company industry as constituted today is just this—the closed-end company is the type of company which raised its money in one offering, say $100,000,000, and then did not sell any more. If you wanted to get out of that company, you had to sell your security in the open market—as countra-distinguished from the open-end company, which raised its capital by continual sales—because the certificate holder could come in at any time and tender his certificate and receive not the amount of money he paid in, but the asset value of the certificate, which, in the last analysis, depends on the market value of the portfolio securities.

Now, we will elaborate upon that as we go along with the specific provisions, but the point I want to make is that one of the fundamental problems, in my opinion, which confronts this industry, is—Is the investment company going to be something that is devoted primarily and exclusively to the management of other people's money, or is it going to become a subservient or secondary function of the company and the primary emphasis be placed on the distribution of the securities? You have that conflict as you go along: Is this business going to depend upon the amount of money you can get from the distribution of the securities and is the emphasis going to be placed upon that, or is this industry going to be an industry where the small investor is going to turn his money over to it and say, "You invest it," and the people who sponsor it get the management fees? We are going to indicate the safeguards we think are needed to place the emphasis upon the investment management rather than upon distribution.

Just one other thing before I go to the analysis of the bill. In these installment investment plans, and that is true also with the open-end companies, there are some companies who perpetrated these practices, and they came to us and they talked to us and they said, "Well, we will make these changes," but the unfortunate thing, Senator, is that this is a highly competitive business. Now, he might be prepared to follow certain principles, but there is no provision in the law which says that everybody else has to subject themselves to the same provisions or limitations. Therefore a person engaged in sponsoring an installment plan, who wants to do the right thing, finds himself handicapped, because the next day a different individual can organize a company and he is under no compulsion or duress, and there are no sanctions which compel him to comply with any standard that the good people in the industry set.

All of the abuses in the installment companies have not been eliminated. I think they have manifested good cooperation. I think they are convinced, as we are convinced, that you cannot meet that problem unless you have legislation.

Although I do not assume to talk for them, my definite belief is that the provisions we have formulated meet the problem substantially and they are prepared to accept them—in fact, they would like to see them adopted—and I think the representatives of that branch of the industry would say so if they were requested to come here.

Senator, before I commence the fairly detailed discussion of the provisions of the proposed legislation or bill, I would like to make one observation. Nobody is more conscious than I am, Senator, of the difficulty of saying in precise language what you intend to accomplish. Now, our experience has been, for instance, that in connection with the preparation of the questionnaire that we sent to the entire investment-trust industry, we had a rough draft, we conferred with the industry, and they were of incalculable help, because you say something and it accomplishes something diametrically opposed, or does things that you did not intend it to do, or accomplishes something you did not intend it to accomplish.

Now, the probabilities are that in a bill of this size there are such situations. I personally and the Commission have had the finest relationship with the industry. I will say this unequivocally, Senator: We have had the utmost cooperation of these people throughout the entire course of our study. I think it is unfortunate, and I am not being critical, Senator, that the industry did not do all they could have done. Whether they were too busy or whether they were trying to ascertain the full scope of this legislation or trying to see if we had any sleepers in the proposed legislation, the fact of the matter is that by and large after the bill was introduced few people from the industry conferred with us. There were some who came to us and indicated that a mere change of a word here would not change the substance, yet would either tighten the bill or eliminate the "bugs" in the legislation. I am candid and frank and happy to admit that those people have been of great help to us. However, although we made the announcement that we were prepared to discuss it with them, it has not happened.

Senator Wagner. Have you had any conferences at all?

Mr. Schenker. Not the same type of conference, Senator, that we had before the bill was introduced. I want to make this clear.

I am not being critical. They probably had a man-sized job on their hands studying the bill and getting all its implications, but the only thing that I and the staff and the Commission feel is that there probably are some little phrases or a misplaced comma that might accomplish something we did not intend to do. What we want to do is to give you the broad purposes of the bill and try to illustrate what is aimed at, the different approaches that you can take to the problem, and why we selected the particular approach that we did.

Now, section 1 is the usual preamble to a bill and just sets forth the findings upon which the bill was predicated and incorporates by reference the reports and the studies of the Commission.

Section 2 contains a broad statement or declaration of policy—what the bill, when it becomes an act, hopes to accomplish.

Now, in that respect, Senator, and I am not going to elaborate on that, I think the declaration is clear on its face and so are the findings. In that respect I would like to read a statement made by Mr. Justice Stone before the Conference on the Future of the Common Law, held August 19, 1936, which is reprinted in 50 Harvard Law Review 4, at page 15:

> I observe in recent statutes a revival of the ancient practice of stating in them the reasons for their enactment. The reasons were addressed, it is true, to the removal of constitutional doubts, but the practice can similarly be made an aid to construction. As the force of judicial decision is enhanced by the reasons given in support of it, so the union of statute with judge-made law may be aided by the statement of legislative reasons for its enactment, or by a more adequate preservation of the record of them in its legislative history.

That is one of the things that impelled the Commission to recommend that the bill incorporate in the form of sections, which are really a preamble, what our findings were and what the purpose or policy of the bill is.

Now, coming to the substantive provisions of the bill, section 3 defines an investment company, and that problem required a great deal of thought and care. In the popular mind an investment company is a company which is engaged in the business of investing, reinvesting, holding, and trading in the securities of other corporations. Section 3 (a) (1) says that an investment company includes a company which says it is an investment company and engaged in the business of investing, reinvesting, or trading in securities.

There are situations, however, where that purpose is not so definitely stated.

Paragraph 2 of section 3 (a) sets forth what we call a statistical formula which will be of assistance in determining whether a company is an investment company or is not an investment company. Substantially, what does section 3 (a) (2) say? It says that a company, a very substantial part of whose assets consists of marketable securities, is an investment company, and that a company which is an industrial corporation, although it may have up to 40 percent of its assets in marketable securities, is not an investment company. That will eliminate all industrial companies which may have invested a substantial part of their funds in fairly small blocks of the securities of other corporations.

We took this formula and checked it against 1,800 companies which registered with the Commission under the Securities Act of 1933 or the Securities Exchange Act of 1934. We excluded all companies which considered themselves investment companies. When we

analyzed the balance sheets of these companies we found that although in the aggregate they had $5,000,000,000 of marketable securities—and by "marketable securities" we mean securities other than the securities of their subsidiaries—very, very few companies were caught by this formula. In order to take care of even those few companies, we have made specific exemptions.

Our approach is that an investment company, for the purposes of this proposed legislation, is a company which is engaged in the business of investing and reinvesting in securities, or is a company which invests and reinvests or holds securities of other corporations, provided that at least 40 percent of its assets consists of marketable diversified securities.

We have set forth this definition in our first report that we transmitted to the Congress back in 1938.

The number of instances that have created difficulty are really negligible. There was only one instance, as I remember it now, where there was some doubt as to whether this formula caught that company as an investment company, and we have made provision for that situation.

What do we go on to say? We say that even if you find that more than 40 percent of the assets of a company are in marketable securities, securities of companies which are not its own subsidiaries, we still say that it cannot be an investment company, within the purview of this legislation if—what? If this company is engaged primarily directly or through wholly owned subsidiaries in a business other than that of investing and reinvesting or trading in securities.

That means what, Senator? It simply means this. Take the Standard Oil Co. The top holding company holds securities of all its subsidiary operating companies. We are not even remotely interested in holding companies. They are not within the scope of this legislation. The Commission does not want any part of that type of situation. So if you take that type of company, even though it may fall within this 40-percent provision, we say it is not an investment company. We say, "You are not within the purview of this legislation if you are primarily engaged in any other business even though you may have a substantial part of your assets in marketable securities."

So that such holding companies are specifically exempt. That will fortify the exemption of companies which are essentially industrial corporations or railway companies which may have a substantial part of their assets in marketable securities.

Then we say, further, that even if you may fall prima facie within the statistical formula, if you can prove that even though you do not do your business through wholly owned subsidiaries but through majority-owned subsidiaries, if you make out a case that you are engaged in a business other than investing and reinvesting in securities, you will be exempt.

Then we go on further to a situation where we have an industrial corporation that has a substantial part of its assets invested in marketable securities. If for some reason they see fit to take that portion of their activities and put it into a wholly owned subsidiary, instead of having their transactions in marketable securities, a sort of division of the company, we say that that wholly owned subsidiary is not an investment company.

Senator WAGNER. That is so, even though the subsidiary might engage in the business of buying and selling securities?

Mr. SCHENKER. On that aspect, Senator, we do not want to let ourselves in for a lot of circumvention, and the test there is: What is your primary business? Suppose there is a company with assets of $100,000,000 that has a small chemical factory worth $2,000,000, and takes $99,000,000 of its assets and puts them into a subsidiary to speculate on the New York Stock Exchange. That is an investment trust.

We say if, looking at the whole picture, his primary business is the chemical business, then the fact that he has a number of his assets in a wholly owned subsidiary which invests and speculates in securities of other companies, does not make him an investment company.

Senator WAGNER. That is where there is discretion. That is not a fixed proposition?

Mr. SCHENKER. No; that is not a fixed proposition. As we go along, Senator, I will try to elucidate those things that prompted us to recommend to your committee that the Commission be given the power to make rules and regulations in connection with that matter. You cannot set down hard and fast rules. I can give you instances showing that it is really doubtful what the primary business of a company is. Are they engaged in speculating in common stocks on the New York Stock Exchange, or are they engaged primarily in the business of manufacturing or in the chemical industry or the banking industry?

Senator WAGNER. I did not intend to be critical.

Mr. SCHENKER. I am glad you raised the point. I do not know whether I have made this clear or not; but with respect to a company which is engaged in a business other than investing in securities through wholly owned subsidiaries, we have no discretion in that at all. That company has an exemption, because, if you will look at the set-up of that type of company, what do you find? If you just pierce the corporate veil and get rid of the legal fiction that every corporation is a separate entity, and just go down from the top holding company to the operating company, the top holding company is really engaged in the operating business. For instance, the Standard Oil Co., the top holding company, is in the oil business. It is not in the business of investing and reinvesting in securities.

In the closer cases, not where you have the top company operating through wholly owned subsidiaries, the closer type of case is this, Senator—and that is what this provision was intended to meet; I mean, section 3 (a) and section 3 (b) (2). Take, for instance, Senator, some investment companies: Their primary business is something like this: Instead of buying securities listed on the New York Stock Exchange and trading in them, they buy big blocks of stocks in particular companies and stay with the investment for a substantial period of time.

Take the Phoenix Securities Corporation. It virtually has no marketable securities in the sense that it has a portfolio of New York Stock Exchange listed securities. A substantial portion of its money is in its control of a block of stock of the United Cigar Co. Another substantial portion of its assets is in Celotex, of which it owns 30 percent. A substantial portion of its assets is in the Autocar Co. A substantial portion of its assets is in the controlling block of stock in the New England Bus Co., and a substantial portion of its assets is

in the Southwest Corporation, which is in the sugarcane business. Recently they found oil there——

Senator WAGNER. What is the name of that company?

Mr. SCHENKER. The Phoenix Securities Corporation. A substantial portion of its assets is in the Loft Co., Inc., which in turn controls the Pepsi-Cola Co. that you have been reading about in the newspapers.

The Phoenix Securities Corporation is not in the business of running cigar stores, not in the business of manufacturing Celotex or raising sugarcane, but has investments in those activities. It is not primarily interested in the manufacture of sugar. It is interested to the extent that if the sugarcane business picks up and makes money, the price of its stock will rise and it can sell its stock at a profit.

So you have this gradation of corporations from the situation where it is clear that the holding company is really engaged in an industrial enterprise to the other extreme where it is clear that the investment company owns small blocks—100 or 500 shares of United States Steel—and cannot even remotely be considered as being in the steel business. Somewhere along that area you have to draw a line as to when it is an investment company and when it is an operating company. And it is with respect to that situation that the Commission says, "You have to make an application so we can take a look at your activities and your assets and then determine whether you are an investment company or not.

I think this also has to be borne in mind, Senator. There is nothing arbitrary or despotic about that. If any individual is aggrieved by a decision of the Securities and Exchange Commission he has a right to appeal to a court to get a judicial review of the action of the Commission on the aspect of whether he is an investment company or not.

Whom else do we exempt? You have the situation where there are personal holding companies. A family may have a substantial estate and has invested its money in marketable securities. In essence that is a private investment company, is it not? We do not want any part of it; and so we have said that even though you engage in the same type of activity as an investment company, which is within the purview of this section, if you have less than 100 security holders you are not a public investment company and not within the purview of this legislation.

Senator WAGNER. Less than a hundred?

Mr. SCHENKER. Yes, sir.

Senator WAGNER. Irrespective of the amount of securities they may have.

Mr. SCHENKER. Irrespective of the amount of the total assets they may have?

Senator WAGNER. Yes.

Mr. SCHENKER. That is right. The total assets play no part in the determination as to whether a company is a public investment company or a private investment company, because, Senator, these public investment companies run as low as $30,000 or $25,000, and run as high as $121,000,000. The size is not the definitive or determinative factor. The factor which determines whether you are within the purview of this legislation or not is, first, are your activities those of an investment company? Second, are you a public investment company?

In order to prevent easy circumvention of the provisions of the law so as not to come within its scope, we have provided for that on page 7, section 3 (c) (1). Let me give you an example, Senator.

Suppose an individual decided to form an investment company, and he organized an investment company, and then on that company he superimposed another company by having the first company he organized issue all of its stock to the superimposed company. Then the superimposed company sells its securities to the public. The lower company has only one stockholder—the company that was superimposed on it. However, the public has indirect participation in the lower company by virtue of the fact that it is buying the securities of the company which has been superimposed on the lower company.

Unless there is a provision like that, then it is a simple matter to evade it, if the requirement is that there has to be a hundred stockholders. All he has to do is to interpose between the company which is going to be the investment company and the public a corporation which will own all the stock of the investment company. Do you understand, Senator?

Senator WAGNER. Yes.

Mr. SCHENKER. So that this provision says that in computing the number of stockholders to determine whether there are 100 or not, a corporation counts as one stockholder. However, if it has a substantial interest in that investment company, then in computing the number of stockholders to determine whether it is an investment company or not, you have to count the number of stockholders of the corporation which holds a substantial interest in the investment company. Otherwise all they have to do is to superimpose one corporation on the investment company and they are without the purview of this bill.

Senator WAGNER. Just on the general statement that you made, what is the reason? Is there some very good and sound reason for having one company superimposed on another? Is it an improper device, or are there very good reasons for that method of financing?

Mr. SCHENKER. The method of financing depends, in my opinion, upon——

Senator WAGNER. I am only asking for an opinion, because there may be a contrary view, you know.

Mr. SCHENKER. I understand that, Senator. In our opinion, as far as the investment company industry is concerned, not only is there no useful function served by pyramiding one company upon the other, but we feel, and we will elaborate upon that when we come to the sections relating to pyramiding, that it is a distinct disadvantage to the stockholders. In essence, pyramiding is nothing but a device whereby insiders get control of substantial amounts of the public's funds without any substantial investment on their own part. All they have to do is to get control of one company and then to use the funds of that company to buy another, and use the funds of that company to buy another. When we discuss that provision we will show you the lengths to which that has been carried on, and we will also show you, Senator, the extent to which it prevails at the present time.

Senator WAGNER. We have had some instances that have been pretty definite. You mean, you are going to show us other cases in addition to Continental and Founders?

Mr. SCHENKER. The Founders was a very complicated pyramiding system. The Equity Corporation was a very complicated pyramiding system. But if I may interrupt just a second—because you raised this question, Senator——

Senator WAGNER. I do not want to divert you too much.

Mr. SCHENKER. Possibly the most expeditious thing would be to wait until we come to that provision, so that we can show you the situation as it prevails at the present time.

In any event, the problem I have been talking about, Senator, is a little different from the one you suggested.

I am not addressing myself to the abuses of pyramiding. At the present time what I am trying to show is the reason why in some instances you have to consider a corporate stockholder in an investment company more than a single stockholder, because that company may have a very substantial interest in the investment company, and probably may have a very substantial interest in the corporation which has a substantial interest in the investment company.

We specifically exempt these personal holding companies, as I said. We specifically exempt all persons, or substantially all, whose gross income from securities or security transactions is derived from either acting as broker or from the distribution of securities issued by others. In essence, what are we doing there? Although a broker is engaged in the business of buying and selling securities, he is not an investment company. What we say is that if you have an incorporated brokerage firm and it has more than a hundred stockholders, if its business is the brokerage business, it is not within this act.

If you have an incorporated investment banking firm engaged in the business of distributing securities, it is not within the purview of the act.

Then we go on to say any bank or insurance company is exempt, and we have to make that specific provision, because fire-insurance companies invest and reinvest in securities, as do also insurance companies and banks.

We have exempted any common trust fund as defined by the revenue act. Those common trust funds are a sort of investment trust in which trustees can participate, and they are managed by banks and trust companies.

Similarly we have exempted savings banks and small-loan associations, and so forth.

Then we have said that any company which is effectively registered with the Securities and Exchange Commission under the Public Utility Holding Company Act is exempt from this bill.

We have exempted mortgage companies, although they in essence deal in securities.

Then we have exempted oil royalties.

We have exempted all eleemosynary institutions and nonprofit associations; and we have exempted all voting trust arrangements. On those we will have a little something to say when we come to the provisions of the bill relating to voting trusts for investment companies.

We have exempted all protective committees. In addition, we have talked to some representatives of the small-loan business and the acceptance business, companies engaged in the business of buying automobile paper and refrigerator paper, and so forth. If they are engaged in the business of dealing in automobile paper and small

loans, the Commission's recommendation is that they should not be within the purview of this legislation.

However, there is one type of situation that I have in mind, and that may clarify the subject, Senator, in connection with the question you asked.

What type of securities do these companies go into who sell their certificates on the installment plan? There is a company in existence which sells a vast amount of installment certificates, those certificates that Commissioner Mathews described, where the company says that if you pay $10 a month for 12 years it will pay you $1,500. That is really an unsecured promissory note which you are buying on the installment plan. It is not collateralized in the strict sense; it is just a sort of debenture of this company.

Senator WAGNER. Does the investor know that it is just a promissory note?

Mr. SCHENKER. Well, Senator——

Senator WAGNER. You do not know that, do you?

Mr. SCHENKER. Most of the time he does not. I am not being critical in this connection, Senator, because I have personally discussed the situation very carefully with them, and they are not unconscious of the fact that these problems exist. And again, Senator, in this instance I speak with a little more authority.

The fact of the matter is, Senator, that they tell me that I am practically authorized to tell this committee that as far as they are concerned, they want legislation, because they are conscious of their obligation and feel that their type of institution which has $151,000,000 of the public's money, has outstanding contracts involving over a billion dollars and has 300,000 certificate holders, in almost every city in the nation should be regulated.

I am not saying, Senator, that they do not have some difficulties with some of our provisions. The fact of the matter is that we are still discussing it with them, and we hope to be able to work out the problem so that we can come to this committee and suggest something practical that would meet the situation and would permit these people to carry on their business.

Senator WAGNER. Of course you know that the committee is prepared to hear all of those interested in the legislation. Very good suggestions come from those that have a different slant on this question.

Mr. SCHENKER. We have discussed the bill with the representatives of small-loan companies and acceptance companies who came down to see us after the bill was published, and we are trying to work out language which will exempt that type of company, if the committee sees fit to do so, and yet not let out the type of company which sells its certificates on the installment plan, and whose portfolio consists not of certificates which correspond to those of an insurance company, but whose entire portfolio consists of automobile paper and refrigerator paper.

There is one other situation which required consideration, and we have been discussing that with the Federal Reserve Board. I refer to institutions which are known as bank holding companies. A bank holding company is a company which owns at least the majority of the outstanding stock of banks or is in a controlling position with respect to banks; and as the Senators know, under the Banking Act they have to submit to some supervision by the Federal Reserve Board if they want to be able to vote their stock.

So we are in process of discussing with the Federal Reserve Board the language or phraseology which we think would eliminate those bank holding companies which ought to be exempt from the purview of this legislation.

You have, then, a definition of the type of company which is encompassed by this bill, and you have the specific exemptions also. You have the provision which gives the Commission power, in certain instances, to make additional exemptions.

Our next problem was, after the area of investment companies had been circumscribed, to see if we could not set up a simple system of classification of investment companies. That is an important problem, because if you look at the sales literature or the circulars, or even the prospectuses, and particularly if you look at the articles of incorporation of these institutions, they have the broadest powers.

That is a strange thing, Senator. Here is a type of institution which is supposedly organized to invest or handle people's savings. In some respects it is not unlike an equity savings bank, rather than a legal savings bank. Yet, when you take a look at their articles of incorporation they have got the same ones that the United States Steel Corporation has. There is absolutely no limitation in the articles of incorporation as to the activities they can conduct or as to the business they can engage in.

I shall not take much time on that, but I would like to read the topic sentence of each paragraph of the articles of incorporation of a corporation which I have before me. [Reading:]

To manufacture, improve, and work upon minerals, metals, wood, oils, etc.

To manufacture, improve, repair, and work upon any and all kinds of machines, instruments, tools, implements, mechanical devices, etc.

To own, purchase, lease or otherwise acquire lands and/or coal, oil, gas, mineral, and timber rights, etc.

To plan, design, construct, alter, repair, remove or otherwise engage in any work upon bridges, railroads, dams, canals, piers, etc.

To buy, sell, exchange, trade, and otherwise deal in any and all kinds of manufactured articles, etc.

To carry on the business of trucking, warehousing, and storage, including the storage of all kinds of goods, wares, and merchandise, etc.

To acquire, buy, hold, own, lease, manage, and control lands, interests in lands, concessions, railroads, canals, etc.

To acquire, buy, hold, own, sell, lease, exchange, dispose of, finance, deal in, construct, build, equip, improve, use, operate, maintain, and work upon (*a*) any and all kinds of plants and systems for the manufacture, storage, utilization, supply or disposition of electricity, gas or water, etc.; (*b*) any and all kinds of interurban, city and street railways, railroads, and bus lines, etc.; (*c*) any and all kinds of works, power plants, substations, systems, tracks, machinery, etc.

To acquire, buy, hold, own, sell, lease, exchange, dispose of, distribute, deal in, use, produce, furnish, and supply electricity, gas, etc.

To undertake, manage, and control any and all kinds of scientific, historical, geographical, artistic or other enterprises and investigations, and to conduct, promote, and finance any and all kinds of experiments, investigations, expeditions, and explorations in aid thereof, etc.

This goes on——

Senator WAGNER. What is excluded?

Mr. SCHENKER. Nothing is excluded.

Senator WAGNER. Do you mind saying what company that is? That is, is it a substantial company?

Mr. SCHENKER. Well, Senator, I am not citing this as a horrible example——

Senator WAGNER (interposing). I am not talking about that; but is that charter the charter of a very substantial company?

Mr. Schenker. It is a substantial company, in existence at the present time. But, Senator, from the little you have heard, a great many of these investment trusts have gone into that. You have had the instance where a subway was bought in Buenos Aires; where they bought the Venezuela Oil Co., and where they bought other investment trusts.

I want to be clear on this, Senator. This bill does not say that they cannot go into that business. The fundamental approach of this bill is that if you are going to go into that business, you have got to tell your stockholders you are going into that business. If you find you cannot make money, and you want to go into the business of acquiring South American subways, all you have to do is to tell your stockholders, "We have not been able to make money speculating on the stock market; we would like to change the nature of our activities, and since you bought in reliance upon the fact that we were going to deal in listed securities, and we want to change the nature of the business, we are just getting your approval to change the nature of it."

What are the classifications that we have devised?

There is the certificate company which issues these unsecured promissory notes which it sells on the installment plan. That is one type; and we will discuss their problems when we come to that section.

Then there is the so-called fixed trust, which is a device whereby they sell an individual an interest in a package of securities, a list of which is made known. In essence, they cannot change the package except under certain circumstances. He gets a small cross-section of the securities listed on the New York Stock Exchange. Those are put into a package in a safety deposit box, and there is no management, and the value of his interest in that package gyrates with the fluctuations in the stock market. That is why we call it a fixed trust.

Senator Hughes. Does that belong to him or to other stockholders too?

Mr. Schenker. He acquires by the purchase of the certificate an undivided interest in that package. The package consists of quite a few securities in pretty substantial blocks. There is a corporation which is known as the depositor corporation that makes up a package. Each package is identical because the trust indenture specifies the securities to go into the package. It is deposited with the bank, which is a trustee. In essence, it is merely a custodian, because it has no trustee functions. That is one of the difficulties with these installment plans and fixed trusts. They say the bank is a trustee, and you think you are getting a trustee service, that you are getting their investment judgment, their investment advice, when the fact of the matter is that the bank is only the custodian of the securities.

Senator Wagner. Like a storage warehouse?

Mr. Schenker. Yes; like a storage warehouse. They deposit it with the trust company or bank, and certificates are issued representing a beneficial undivided interest in the package. The price of the certificate is computed this way. They take all the securities, find out what the market value is, the total market value, and divide it by the number of certificates outstanding, That gives you the present market value of the certificates; and then they sell new certificates to the public.

Senator HUGHES. There may be hundreds that are interested in that particular package?

Mr. SCHENKER. That is right, Senator. Legal title of course is in the trustee. The certificate holder, in legal contemplation, is the cestui que trust.

Senator WAGNER. You say they have a trust indenture?

Mr. SCHENKER. That is right.

Senator WAGNER. Which sets forth the securities held?

Mr. SCHENKER. Yes.

Senator WAGNER. Is there a provision that those securities cannot be substituted for other types of securities?

Mr. SCHENKER. I will take one second to explain that, Senator.

Senator HUGHES. They can be sold, can they not, and others substituted?

Mr. SCHENKER. That is the same question that Senator Wagner asked. I will take a minute to explain that.

The first type of investment company was the closed-end type. Let us say the company decided to raise $100,000,000, and in one public offering they raised it, and that was the fund they managed for the public. Up to October 1929 almost all the investment companies ever formed in this country were of that type. They raised $100,000,000 or $60,000,000 or $50,000,000 through one public offering; and the emphasis, of course, as you have heard from Mr. Stern in connection with the Founders group of investment companies was that this was a device to give you expert management and diversification. And I am not being critical, because hindsight is better than foresight. But the expert management did not materialize; and after the crash in 1929 the management companies sustained terrible losses. As we will show a little later on, Senator, some of those losses were not attributable merely to the decline in security prices. Some of them were attributable to transactions between the insiders and their investment trusts.

But in any event, these companies which were supposed to be managed by experts sustained bigger losses, or as big losses as anybody else, whereupon the confidence of the American public in the expertness of the people who were managing these companies faded a little bit. As a consequence, you found that investment-company securities were selling at what we call a discount; that is, that their market price was less than their asset value. If you liquidated the company and realized the market value of the securities that the company held, and distributed it to the stockholders, the stockholders would get $50 per share. However, the securities were not selling at $50. They were selling in the open market for $25. In many instances there was a lack of confidence of the American public in the expertness of their management, because they were in effect saying that a dollar in the hands of these expert managers is worth only 50 cents.

So there was this reaction about these managements, and an individual who wanted to liquidate his interest in an investment company had to sell his securities at a discount ranging in some instances up to 50 percent.

Then they devised these fixed trusts. They said the difficulty with investment trusts in the past was that you had too much management. You did not know ultimately in what security your money was going to be invested, because these managers had the broadest

power. They could invest in anything. So they said, "We will eliminate the abuses of these closed-end management companies. First, we will tell you in what securities we are investing, and we will never shift. Secondly, we will make this arrangement, that if you want to tender your certificate you can get in cash or in your aliquot share of your securities, the asset value of your shares."

So in that respect they were open-end companies.

We will have somebody describe the terrific amount of securities of fixed trusts which were sold. My recollection is that in a short period of time they sold $800,000,000 of fixed trusts.

What happened? They bound themselves in their trust indentures so rigidly that they could not eliminate or substitute the securities except upon the happening of a certain contingency; and one of the early contingencies was that if the company passed a dividend it had to be eliminated. But when a company passed a dividend, that was the worst time to sell its securities. So they had to eliminate out of the package those securities which passed a dividend, which was the worst time in which to eliminate them.

Through the years, through experience, they became less rigid, so that today, in essence, a great many of them are really management companies which disclose what they call the primary list of securities they can invest in, and a so-called secondary list from which they can substitute into the primary list.

Does that make it clear, Senator?

Senator Wagner. Yes. That secondary list is set forth, is it?

Mr. Schenker. It is. But there are a great many aspects of that. In many instances the management has a right to change the secondary list without the consent of the stockholders, and so forth.

The third type of company is the so-called management company, where the management is given untrammeled discretion as to the investment that can be made. There are, therefore, three big categories of investment companies: Face amount certificate companies, fixed trusts, and the management investment type where the management has the right to make any investment it wants to, except in some instances, subject to certain limitations.

Here you have this big class of management investment companies, and it was incumbent upon us to try to get a subclassification of these management investment companies.

There is a broad classification based upon whether the stockholder has the right to tender his certificate and get his money, his asset value, or whether he does not have such a right. We say the management investment companies are divided into two broad classes: One, open-end which gives the stockholder the right to compel redemption of his share; and closed-end companies into which he does not have that right.

I would like to point out, Senator, that the open-end company is the one in which the stockholder can compel the company to redeem his share. It is not the situation where the company can call his stock, as in the case of callable preferred stock. The right to require the redemption must be in the stockholder.

Having subdivided these companies into those in which the stockholder has the right to tender his security and get his asset value, and those companies in which he does not have that right, we then tried to classify management investment companies on the basis of

their investment policies. The first classification is really one of structure; the second classification is based upon the answer to the question, "What is the nature of your activities? What are you going to do with the money that is turned over to you to invest?"

Senator WAGNER. I would like to ask a question here that I forgot to ask Mr. Bane when he spoke about open-end corporations. He recited instances of diluting the assets by fixing the basis of redemption, I suppose you might call it. Was that the general practice of open-end corporations, or was that just in specific instances? Was that a general practice, or not?

Mr. SCHENKER. Senator, the only way I can answer that question is that that dilution is possible in every open-end company.

Senator WAGNER. I understand that.

Mr. SCHENKER. As to the extent to which it was done actually, I think Mr. Bane is better qualified to pass upon than I am.

Senator WAGNER. I will ask him at another time.

Mr. SCHENKER. He made a specific study.

Mr. BANE. You can ask me now if you want to, Senator.

Senator WAGNER. Perhaps this is a good time to ask it. I forgot to ask you that question before.

Mr. BANE. I presume you are referring to instances where they could redeem the share at a greater price than the share was worth at the particular time of selling?

Senator WAGNER. Yes.

Mr. BANE. That was not the practice in all cases. There were generally three ways, with some minor exceptions, by which shares were redeemed. You sell today at a price based on yesterday's close. The market has risen. You present your share for redemption. You get his redemption price; you know the closing price of the market this afternoon. If that is higher, you get a higher price for the share, of course, than the price at which the share sold.

There are other cases where you get, on redemption, the asset value of the stock at the moment or hour you present it for redemption. If the price on a rising market is higher than the closing price the day before, you would, of course, get a larger price for your share than the price at which the share is selling.

There are other cases. Another one is that you present your share for redemption today. You are paid the price as of tomorrow's close. There, of course, you take the chance of whether tomorrow's close will be higher or lower than the price at which you buy.

I should say most of these cases, in my estimation, fall into the first two classes.

Senator WAGNER. Of course the industry may be able to explain that as a perfectly proper practice, but it seems to me that the investor was not being treated fairly there.

Mr. BANE. That was the point I tried to make, Senator.

Senator WAGNER. If you sell at a lower price than the actual redemption value, you are depriving the present shareholder of a part of that fund to which ordinarily he would be entitled. Is not that so?

Mr. BANE. As Judge Healy suggests to me, Senator, it is like watering good whisky.

That is quite general; and I tried to make it clear that during the periods when the market price rose, in a great many of these trusts it is possible to buy the securities right now and at the next moment

turn them back at a price that will give the purchaser a substantial profit.

Senator WAGNER. I suppose an insider knows he can make a very good profit there.

Had you finished, Mr. Schenker?

Mr. SCHENKER. I have not completed my statement, Senator.

In our analysis of the investment company industry, Senator, we virtually studied every one that has ever been in existence in this country. We find that you can make three broad categories of subclassification and still be able, if proper disclosure is made in the registration statement, to apprise the prospective purchaser of the investment company's security of the nature of its activities.

You have to read, Senator, section 5, which classifies and subclassifies these companies, in conjunction with section 8 (b) (1) on page 17, which contains the provisions with respect to what the registration statement should contain, and in connection with section 13 on page 30, which deals with changes in investment policy.

The whole three sections are integrally interrelated, because it is a problem of disclosure to stockholders.

The first class is in section 5 (b) (1), which is known as the diversified investment company. In essence that paragraph says this: That a diversified investment company is a company which will not invest more than 5 percent of its assets in the securities of a single corporation and will not own more than 5 percent of the outstanding securities of that corporation.

In other words, a diversified company must have at least several different securities in its portfolio, and cannot make investments which will put them in a controlling position in the company in which they made the investment.

There is one little adjustment that we made in that general definition. You have heard a great deal, Senator Wagner and Senator Hughes, about the necessity for new capital for industry, and here you have institutions which represent probably the biggest pool of liquid funds in this country. In order not to make it impossible for this type of company to make new funds available to industry, we have said, "You may still retain your status as a diversified investment company if you desire to use up to 15 percent of your total assets in underwritings or loans to certain companies."

So that section says that a diversified investment company is a company 85 percent of whose assets consist of cash or securities in each issue of which it does not have more than 5 percent of the investment company's assets and each issue of securities held does not represent more than 5 percent of the outstanding securities of the issuing corporation.

With respect to the reservoir of 15 percent, you are not limited by these restrictions.

There is one other little angle, and that is with respect to this 15 percent reservoir. We say you can own more than 5 percent of the outstanding securities of any one corporation, but you cannot invest more than 5 percent of your total assets in any one portfolio company. Why do we say that? Take a small company that needs some capital. This diversified investment company wants to make capital available to it. The investment company will want to take a ride on the prob-

able success of the small company in which it is making the investment; so the probabilities are it will not take the form of a loan; it will take the form of an investment in the stock of that small company.

You have a situation where the investment company may be making a substantial investment in a small company which does not have a market for its securities. It is an un-liquid stock. Therefore the investment company must be in a position where it can have some control or influence over the management. So, therefore, we say that in this situation where you want to make loans or you want to make capital available to industry, you can have a controlling position in that company; and therefore we do not limit you to 5 percent of the outstanding securities, although we do say you cannot put more than 5 percent of your total assets in that small company.

Is that clear, Senator?

Senator HUGHES. Yes.

Mr. SCHENKER. So, the first characteristics of the diviersified investment company are those I have stated. You notice that its name signifies diversification of investment rather than controlling influence.

The first limitation is with respect to the amount of money they can put into one company and the amount of securities of any one company they can own.

Then we go on to say that the portfolio turnover of a diversified investment company during its last fiscal year must not exceed 150 percent.

What does that mean?

I see that some of the representatives of the industry are waiting for me to explain it. They evidently have had some difficulty with it; and it is not an easy problem, Senator. Let me tell you what the principle is, and then we will see if the language says what we intend it to say.

You can invest your money in an investment company in the belief, or in the representation, or in the hope that the company is going to make analyses of the various industries in this country and is going to pick those industries which, in its opinion, show the greatest prospect for development. They are going to buy stocks in those industries and stay with them for the long-term pull, and are not even remotely interested in the intermediate gyrations of the price of the stock on the stock exchange.

A lot of people have told us that they are not interested in short-term trading; they are interested in the long-term trading, say in the chemical industry. They are prepared to make their investment in the chemical industry, and what the immediate public appraisal of the chemical industry is that is reflected on the stock exchange is of no interest to them. That is one type of company. You turn your money over to expert investors who are going to analyze the industry and pick out an investment for the long-term pull.

On the other hand, a fellow says, "I am not interested in the long-term pull; I am interested in beating the stock ticker tape. I have got a scheme where I can give you quick profits. I will get in or out of certain stocks rapidly, I can guess when there is going to be a change in the trends in this country, when the utility industry is going to be good and when the steel industry is going to be good and when the automobile industry is going to be good. So that primarily my activities

are going to be different. I am going to trade fast, either in one security, or I am going to shift my position rapidly from one industry to another."

We say those two companies are two different animals. One is an investment company and the other essentially is a trading corporation. An individual who invests something in an investment company ought to be told whether it is the first type of company or whether it is the second type of company.

That problem was recognized by the Treasury as being a very essential problem, because in connection with section 48 (e) of the Revenue Act which gives the open-end companies a tax preference, it says that you cannot get this tax preference if more than 30 percent of your gross income comes from the sale of securities which you have held less than 6 months.

So that was their idea to protect against quick portfolio turn-over and shifts in portfolio.

The industry had some difficulty with that. Why? Well, in order to get within that provision they would deliberately sell stocks upon which they might take a loss so that would keep down the amount they made on securities they sold which they had held less than 6 months.

We said that the criterion or the test of whether you are an investment company or a trading corporation is, How fast do you turn over your portfolio? How fast do you get in and out of stocks? If you turn over your portfolio more than one and a half times you are a trading corporation.

Let me explain that just a little, Senator. We say that if your total purchases and total sales of portfolio securities are one and a half times your average total assets, then you are a trading corporation, and if it is below that you are not a trading corporation.

We have also taken into consideration that in computing the portfolio turn-over ratio they do not have to consider the securities they bought by virtue of the fact that they raised new capital. In that instance we recognize the new capital.

I am not unmindful, Senator, and it is not an easy problem, that there may be some difficulty with this portfolio turn-over. The thing we have no difficulty with—and I think the industry does not have any difficulty with—is that there ought to be a distinction between those two types of companies.

Recently an individual came to me who wanted to organize an investment trust. We have no jurisdiction. He brought in a chart about one-third the size of this table, with a lot of lines and blue circles and red squares on it. He said, "I want to organize a trading trust with particular emphasis on short selling."

This bill does not say he cannot do that, Senator. What this bill says is when you sell your securities you are going to tell the public the type of trust that you have. If you have a long term investment trust and overnight either you or somebody to whom you turned this trust over has got some ideas to play the stock market, the stockholders must be apprised and their approval obtained.

Our definition of portfolio turn-over is contained in section 45, subsection (30), page 93 of this bill.

We can conceive of a situation where an emergency is present and the best policy is to sell the stock and get into a cash position and,

after that emergency blows over, to reinvest all of that money. Our study showed that such a situation has never existed up to the present time. What does our study show? We have analyzed the portfolio turn-over of a great many companies. In a sense this 150-percent ratio is arbitrary, as any percentage is arbitrary. What we tried to do was to take a big cross section of the industry and see what their portfolio turn-over was, and then on such reasonable ground to say: "If you trade above that you are a trading corporation. If you trade below that you are an investment company."

We made an analysis for the years 1936 through 1939 for 23 companies, 9 open-end companies and 14 closed-end companies.

Using the formula that we devised we found that there were only 2 companies that had a portfolio turn-over ratio of 150 percent. That percentage cannot be unreasonable, Senator, if only 2 companies out of 23 active companies exceeded that ratio.

In 1936 to 1938 there were 4 companies, and in 1937 there were 7 such companies which exceeded 100 percent. In 1939 there were only 2. So that in 1939 there were only 2 companies of the 23 which exceeded 100 percent, and our limit is 150 percent.

What is the other situation? We made an analysis for the year 1935 of 134 companies, Senator. Of these there were only 21 which had portfolio turn-over ratios of over 150 percent. That is a comparatively small number; and we say that if you have more than that turn-over you ought not to bear the label of a diversified investment company. There ought to be a disclosure that the company is a trading corporation.

Since 1935, 5 of these 21 companies have been liquidated.

Let me give you some illustrations. I will omit names. There was 1 company which had "trading corporation" in its name and its portfolio ratio for the year 1935 was 1,558.4 percent. That means it turned over its portfolio 15 times in 1 year, Senator. It bought and sold securities of an aggregate value 15 times greater than its average assets.

Then we had another company whose portfolio turn-over ratio was 1,376 percent.

Another one was 991; another was 978; and this one had the name British Type Investors. A person buying that security thought he was buying into a company which was comparable to the investment trust institutions in Great Britain; but he walked into a company which turned over its portfolio 10 times in 1 year.

Similarly, down the line until you come to the last one, which had a portfolio turn-over ratio of 154 percent.

Senator WAGNER. On the radio I have noticed that speakers often say "The index here is so and so." The average person does not know what he is talking about. I think you might help by just giving the figures, that the cash assets are so much and the sales represent so much.

Mr. SCHENKER. Assuming that a company has $100,000,000 of assets, that means, under this formula, that he can do any one of a variety of things. He can sell $75,000,000 of securities, or he can buy $75,000,000 of securities in 1 year. He can sell $50,000,000 and buy $100,000,000. So that he can buy and sell securities in an amount equal to $150,000,000 during that year. If he exceeds that, then he has no right to call himself a diversified investment company.

Senator WAGNER. And the assets are $100,000,000?

Mr. SCHENKER. Yes, sir. The industry probably will say—and I am not depreciating it—"That is all right. You tell us we cannot bear the label of diversified investment company if we exceed 150 percent. But what would probably happen if there is an emergency? If I have to buy more than 150 percent I violate the law and therefore I may have committed a crime, while in the Revenue Act the only consequence is that we lose the tax preference."

I am not unmindful of that, and I think that possibly the language of this provision requires a little more consideration. That is why we thought the industry would come in with suggestions. But I do not think there can be any compromise with the principle, Senator, that if a company is going to be a trading company it ought to be known to the public as a trading company. Is that clear?

Senator WAGNER. Yes; that is clear.

Mr. SCHENKER. Also, a diversified investment company is a company which can only have one class of securities outstanding, and it does not control or own any voting security issued by another investment company. That means a diversified investment company is a company which diversifies its investments, has a simple capital structure, is not pyramided above any other investment company and does not turn over its portfolio excessively. There is the added reservation, however, that if they feel that they can contribute capital to industry up to 15 percent of their assets, they are not subject to the provision that they cannot own more than 5 percent of the securities of corporations.

That, to our mind, at least conforms to what the popular concept and our concept of what a diversified investment company is. It should be diversified. It should be an investment. It should not be speculating. It should have a simple capital structure. It should not be pyramided on any other investment company.

Now, we go on to say that another type of company is the securities trading company. That is a company which conforms to the requirements of a diversified investment company insofar as they relate to not having more than 5 percent of its assets in another company and not more than 5 percent of the outstanding securities of an issuer.

The last classification we have is the securities finance company. If anybody feels, Senator, that his management is such that he cannot be hamstrung by limitations, the only thing he has to do is to register as a securities finance company and tell the public, "I am not limited to the extent to which I can turn over the portfolio and I am not limited as to the percentage of securities of companies I can invest in and the extent to which I can invest in a particular company." But we say that if he wants to bear the label of a diversified investment company, and if he wants to bear the label of a securities trading corporation, then he has got to meet these basic elementary requirements. If he does not want to be subject to these restrictions, if he wants to be able to invest in any security at any time anywhere at any rate in any company in any country, he can do it, because the last clause relates to the securities finance companies.

But we do say that "In your registration statement you should tell the public what your fundamental investment policy is, so that a person can be apprised, even though you are in that broad category—securities finance companies—as to substantially what type of activity you are going to carry on. If you undertake that type of activity in

the first instance, you cannot change that fundamental activity overnight without telling your stockholders and getting their approval."

Senator WAGNER. It is 1 o'clock now, Mr. Schenker.

Mr. SCHENKER. Can we go on a little while this afternoon, if you are not getting bored?

Senator WAGNER. I think we might go on perhaps. We will take a recess until 2:30 this afternoon.

(Whereupon, at 1 p. m., a recess was taken until 2:30 p. m. of the same day.)

AFTER RECESS

The subcommittee resumed at 2:30 p. m. on the expiration of the recess.

Senator WAGNER (chairman of the subcommittee). The subcommittee will resume. You may proceed, Mr. Schenker.

FURTHER STATEMENT OF DAVID SCHENKER, COUNSEL FOR THE INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. SCHENKER. Now, Senator Wagner, in connection with diversified investment companies——

Senator WAGNER (interposing). Please keep your voice up so all may hear you.

Mr. SCHENKER. Pardon me. There is one additional aspect I would like to indicate, under the Delaware Corporation Law a company cannot redeem its own stocks unless it is a special stock. Therefore most companies which are open-end investment companies that are organized in Delaware may have to issue a small amount of common stock, a small block of common stock, so that they may issue a great number of stocks which they can sell to the public which can be redeemable. That is a technical aspect for which we have made provision in the bill.

Now, on page 11 of the bill, subsection (c) of section 5, is a provision to accommodate for this type of situation. A company may have 5 percent of its assets in the securities of one company, and then because of market appreciation in that security, and the appreciation in the remaining securities in its portfolio at a particular point of time, this original block of stock may constitute more than 5 percent of the assets of the company.

Now, that increase of percentage in the total value of the portfolio was not due to the fact that the company bought more securities, but was due to the fact that the market appreciated. And this provision, (c), has been recommended to accommodate that situation.

The company does not lose its status as a diversified investment company merely by reason of the fact that the value of its holdings increased because of market appreciation.

Otherwise you would get this situation: An investment company has $5,000,000 of assets. Let us say the investment company has a block of portfolio securities of a single issue. Now, let me stop for a minute, let us say a block of stock worth $50,000.

Senator WAGNER. Well, which is it?

Mr. SCHENKER. It is $50,000.

Senator WAGNER. All right; go ahead.

Mr. Schenker. They bought a block of stock that gives them $50,000. They do not violate any provision in respect to their being a diversified investment company. They do not buy another single share of that stock, but the market price of those shares goes up so that the block of stock is worth we will say $60,000. Well, they do not lose their status as a diversified investment company even though this stock now is worth more than 5 percent of their total assets. They only lose their status as a diversified investment company by virtue of their purchasing additional securities to the extent of more than 5 percent.

Senator Wagner. I see.

Mr. Schenker. Now, the next provision is (d) of section 5. You will probably hear a little about that. That is the one which says:

> The Commission shall have authority——

Senator Wagner (interposing). What page of the bill are you on?

Mr. Schenker. Page 11.

Senator Wagner. You may go ahead.

Mr. Schenker. That section provides:

> The Commission shall have authority, by rules and regulations in the public interest, or for the protection of investors, to make further classifications and subclassifications of investment companies according to organization, capital structure, nature of assets, amount of assets, investment policy, character of business done, or any one or more other characteristics which the Commission deems significant and which are consistent with the definitions contained in this section and section 4.

Now, superficially that looks like a very broad power vested in the Commission, and the language would indicate that. But there are several observations I want to make with respect to that language.

In the first place, that does not give the Commission one iota of power to impose new liabilities or obligations, or subject new classes of people, to the purview of this language. This is a reservoir of power in the Commission to relieve people.

Oh, I am sorry—I am thinking of another section. This provision here is no wise relates to any restrictions which the Commission can impose with respect to the investments the companies make.

Now, some may try to construe it that way. If the language is not clear on that point maybe it ought to be tightened up.

What this provision says is this: You take the broad reservoir of the third type of company which includes every other type of company. You may get situations where you may further want to subdivide that class so that the purpose, the activities, and the nature of the company would be made more clear to the investing public.

Let me give you a case: We talk about diversified investment companies. You take even the first class, and ordinarily in the popular mind the term "diversified investment company" connotes that they are not limited in their investments to a particular industry but that they can go into a cross-section of securities representing every type of industry in this country. But there are some investment companies which, although they comply with the provision that no more than 5 percent of their assets shall be in one corporation, and no more of that securities corporation should be owned by the investment trust, have limited their investments to special industries. You have companies which specialize in chemical stocks, and I know Mr. Eberstadt will not take umbrage at this if I use his company as an example.

The chemical fund, that means he invests substantially all his funds in chemical stocks even though he complies with the requirement that not more than 5 percent of his money shall be in one company and not more than 5 percent of one company's securities shall be owned by him.

Now, if that type of company should prove to be perhaps misleading to the investor in that that company has a general label "diversified investment company," and it really is not a broad diversified company but specializes in chemical stocks, then the Commission says, "By rules and regulations, we can create a new class in which you will call yourselves a specialized investment company."

Senator WAGNER. Would that be so if no more than 5 percent was invested in any one chemical company and no more than 5 percent of the chemical company was owned by them?

Mr. SCHENKER. That is correct.

Senator WAGNER. You would still say that that would not be, in the ordinary sense, a diversified investment company?

Mr. SCHENKER. Under the present definition, that would be classified as that.

Senator WAGNER. I mean, what would be the ground of your excluding that? Because it dealt only in chemical stocks?

Mr. SCHENKER. That is right; it is a diversified company in a single industry, but it is not diversified as to industries.

Senator WAGNER. I just wondered why that would not be diversified. There might be different chemical companies dealing in different chemicals that would be foreign to one another, as different as a steel corporation.

Mr. SCHENKER. The present bill calls them a diversified investment company. They are not excluded from the class. However, you may recognize, Senator, that at the same time you will get, as you have gotten in the past, investment companies which were diversified in different companies in one industry, as distinguished from companies in different industries, and that is the purpose of this section.

Senator WAGNER. Must they take the initiative?

Mr. SCHENKER. No; the only thing it says is that at some future time, if the Commission feels it is to the interest of the public or for the protection of investors, the Commission shall have the power to make further classifications and subclassifications.

Senator WAGNER. All right.

Mr. SCHENKER. And we say, "which the Commission deems significant and which are consistent with the definitions contained in this section and section 4."

You cannot visualize the combination of companies that may be attempted. For instance, assume that that company I told you about has automobile paper in its portfolio. If experience proves that the protection of the investor requires that that type of company bear a special label, section (d) will give the Commission the power to create that type of company, and he would have to classify as that type of company.

That is the only significance of that provision. It is not intended to tell them where to invest their money, how to invest their money, and with whom to invest their money. We say that at some future time it may be desirable, for the protection of the investors, to have a subdivision of the three primary classifications that we have at the present time. That is the signficance of subsection (d).

Now, section 6 deals with exemptions and says:

The following investment companies are exempt from every provision of this title except section 7 (d).

Section 7 (d) is the section which says that an investment company, unless it is registered, cannot publicly offer securities.

Now, what companies are included within this category? First, you have a company which is not organized under the laws of the United States or of a State. That means that a foreign corporation has got a complete exemption except that he cannot sell his securities in this country.

Now, we had to take that approach, Senator, because you may have a foreign corporation which has not sold securities in this country, yet wants to buy securities on the New York Stock Exchange. We say that a foreign investment trust, although it has not any securities in this country, should not be deprived of the use of the New York Stock Exchange and New York Curb.

You may ask, Why don't you let foreign corporations register? We do not permit foreign corporations to register in this bill. The answer to that is that he may register. As a foreign corporation, we would not have any jurisdiction over him, so he will get the benefit of being a registered company, which may or may not help him in his sales talk up in Canada, and yet not be subject to the provisions of this bill. So we say, with respect to foreign investment companies, you are exempt from the provisions of this act, you cannot sell your securities in this country, and you cannot be a registered investment company under this bill.

Now, paragraph (2) exempts an investment company which is organized under the laws of, and having its principal office and place of business in, Alaska, Hawaii, Puerto Rico, the Philippine Islands, the Canal Zone, the Virgin Islands, et cetera. That is a similar problem. It is not that you do not have jurisdiction over them; they are so distant from America that the policing aspects are quite difficult. We have that problem in connection with exchanges in these islands, and so forth.

It says you are exempt. However, you are not exempt if you try publicly to sell your securities in this country. As long as you limit the sale of your securities to these territories, then you are exempt. If you want to sell your securities in the United States, then you have to register.

Now, the third paragraph exempts companies which at the time of the enactment of this legislation, if it be enacted, are in receivership. Those companies are exempt. However, if they go into receivership after enactment of the title, then the Commission has some jurisdiction with respect to them.

Now, subsection (d) on page 13 makes provision to grant the Commission power to exempt employee securities companies. Now, these employee securities companies exist in great variation. You have got the type of employees securities company which is virtually an eleemosynary institution, which the investment company sets up as a sort of savings plan for his employees; and, on the other hand, you may have a situation like the Hobson Employees Co., which was not so eleemosynary—at least. from the point of view of the employees.

Now, the only way you can deal with that problem is by making an application with the Commission and the Commission studying

the situation. If it feels that it is of the character of category A, then the Commission is empowered to exempt it either fully or under conditions, or to impose upon it such conditions as the Commission feels necessary in the public interest or for the protection of the investor.

Now, we come to provision of subsection (c), and that is the one I started to discuss a little bit before. That one says:

> The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that the Commission finds such exemption necessary or appropriate in the public interest and consistent with the protection of investors.

That is the one that has this awful broad sound. As I started to say before, this is the section which gives the Commission power not to impose any new obligations or liabilities but to exclude either transactions or persons or classes of securities, from the umbra of the bill.

Frankly, Senator—and I have heard some rumblings about this section—I cannot understand the difficulty with it. Now, you will probably hear some discussion about the technical nature of this business and about the difficulty of making provisions for regulating an industry which has so many variants and so many different types of activities, and it is precisely to meet that sort of argument that this provision is inserted.

You cannot possibly anticipate a transaction which you feel should not come within any specific provision of this bill, and you cannot possibly anticipate any person who may or may not come within the specific provisions of this bill.

Now, the fact of the matter is that, in connection with the passage of the Securities and Exchange Act of 1934—and I remember it quite distinctly—Richard Whitney for hours talked at the public hearings on the bill and insisted that the Commission take that power. He said, "Why do you want to hamstring yourselves? You cannot possibly anticipate things that may happen. If you run across a situation that you feel is not within the purview of any particular provision, you will be able to exempt it."

As Judge Healy said in his opening statement, the very first problem that the Commission had was the registration of thousands of securities on the exchanges and the regulation of all the exchanges. It had to be done in a short period of time. If it were not for the fact that the Commission had the power to exempt those that were registered at the time for a period of 60 days, it would have been in difficulty. What they did was that anyone who as presently registered on the exchange was exempted from the provisions of the bill for 60 days, and that gave us 60 days to work out the exemptions of the bill.

If you are going to look for bugaboos, you probably can find them, but this is written to meet those which are not anticipatory. This says not that we can go out and bring new people under the act, not that we can impose new obligations. The only thing that this provision says is—if conditions exist or arise which manifestly are not within the legislative intent of this legislation, then the Commission should be in a position to exempt those in that situation, and the industry should not be required to go to Congress to get a statutory enactment to meet that specific situation.

Now, subsection (d) implements subsections (b) and (c). As I understand it, Senator, in connection with the Holding Company Act, there were certain situations where an industrial corporation owned its own generating plant. I am giving you this example as a hypothetical situation. Now, the Commission did not want the company which owned the generating plant to file an elaborate registration statement, just because it was a holding company. Yet it found itself in the position where it could not exempt the holding company completely. It did not want to exempt it completely; yet it could not subject the holding company to provisions of the act without the holding company first registering. That is the way that statute was written. The Commission could only grant exemptions to a registered holding company, so you had to register in the first instance before it could exempt you from the provisions.

What we are saying here is that if a situation like that exists we do not want that company to register. Yet we feel that it should be subject to some provisions of the bill. For instance, if the Commission felt that the employees' securities companies should not be required to register, it could say, "This company does not have to be registered provided there is no dealing between the company and the investment company; that is, the employer corporation shall not sell any securities directly to the employee corporation."

Under this section, provision is made that the company is not required to be registered in order to subject it to specific provisions; and, conversely, it could relieve it from all provisions, including registration, and just subject it to those which they thought were particularly applicable to that company.

Now, section 7 is the section which is really the heart of the legislation, in that it says that no investment company, unless it is exempt or unless it is registered, can use the mails or an instrumentality of interstate commerce. An instrumentality of interstate commerce includes the facilities of the securities exchange to sell portfolio securities or its own securities, to buy other securities, or buy back its own securities.

An investment company, unless it is registered or exempt, cannot engage in any business in interstate commerce and it cannot control any company which is engaged in interstate commerce or uses the mails or any instrumentality of interstate commerce.

Now, subsection (b) is a similar provision for the people who are connected with fixed trusts.

Subsection (c), on page 16, says that no promoter of a proposed investment trust shall use the means of interstate commerce to sell preorganization certificates. That is a technical problem, Senator, which becomes quite important in connection with this legislation, because we say that no investment company can be registered with us unless it has got at least $100,000 of assets. That means he would have to raise $100,000 among his friends or by private offering. If he could raise the $100,000 in the preorganization stage by a public offering, then we are not accomplishing anything. This subsection is to insure that the moneys raised in the preorganization stage shall be by private offering, rather than public offering.

Subsection (d) is a provision saying that no foreign company can make a public offering of its securities in this country—that is, a foreign investment company—and it says:

> No investment company, unless organized under the laws of the United States or of a State.

That supplements those other provisions with respect to foreign corporations: One which says that a foreign corporation cannot register; two, that it is exempt from all the provisions; three, that he cannot sell his securities in this country.

Senator WAGNER. He cannot sell them unless he registers?

Mr. SCHENKER. He cannot sell his own capital securities, and he can never do it, Senator, because this provision says he cannot register.

Now, section 8 is the mechanics of the registration of these investment companies, and the mechanics set forth is that the company may register by filing a notification of registration, which will be a simple form, and the registration becomes effective immediately upon receipt of it by the Commission.

Senator WAGNER. Mr. Schenker, are there any of these foreign companies now that are doing business?

Mr. SCHENKER. Well, there are foreign investment trusts.

Senator WAGNER. I mean, have you found any difficulty there?

Mr. SCHENKER. Of course, we had no jurisdiction over them in our investigations.

Senator WAGNER. I wondered if you had had some contact with them.

Mr. SCHENKER. There are some people in this country, of course, who own Canadian trusts, and I think that you cannot avoid securities seeping over the boundary, even with these provisions, so that eventually there will be some infiltration of these securities into this country. At least, it cannot be done through a formal public offer.

Now, I described subsection (a) in section 8.

Subsection (b) says that the registered investment company—that is, the company that filed this simple notification of registration—is required in a reasonable time to fill out a registration form which the Commission will prescribe.

Now, what are the things that are going to appear on that registration statement? It says:

> A description of the investment and management policies and of the business done and to be done by the registrant, including "What class are you? What activities are you going to engage in? What portfolio securities do you have?"

And in addition to that, the type of information that would be required if you were going to file a registration under the Securities Act of 1933.

The registration of these companies, Senator, will require the information required under the Securities Act of 1933, and in addition, a more specific elaboration and a more precise enumeration of the particular activities in which they are going to engage.

What have we done, Senator? In order to eliminate the duplication, we have made provision that if the company has filed under the Securities Act of 1933, or if it has filed under the Securities Exchange Act of 1934, it can use that registration statement and just add the

supplemental information which is required to make its registration under this act complete, so that we have at least attempted in our recommendation to the committee to eliminate that duplication.

Subsection (d) says in effect that when the Commission finds that a company has ceased to be an investment company, then the Commission, upon such conditions as it deems necessary for the protection of investors or the public interest, shall cancel its registration as an investment company.

We come to section 9, which deals with the registration of certain affiliated persons and underwriters. That provides that:

> It shall be unlawful for any person, unless registered under this section, to serve or act in any of the following capacities for a period exceeding 60 days.

We have taken these 60 days to give them some time to move around. If a person is going to become a director of a company, he can act for 60 days. In the interim he can file his registration with the Commission and the Commission can pass upon it. In other words, he can take his duties up within those 60 days.

Whom do we desire to register with respect to this—an officer, director, manager, or investment adviser? Those are the people who run the company. Also, the depositor, manager, or investment adviser of or for a registered unit investment trust. Also the principal underwriter for a registered open-end management investment company, registered unit investment trust, or registered face-amount certificate company.

Then there is the distributor, who sells these installment plans, and I will explain why we included that last category in a moment. Broadly stated, this provision requires the registration of the people who are closely associated with the management of the company and the distribution of its securities.

There are one or two points about this provision that I would like to emphasize. In the first place, Senators, you will notice that there is no provision made in this legislation which says that the Commission for any cause can revoke the registration of an investment company. That would be a broad power, because the Commission really would be able to control whether the company stays or does not stay in business. We have found in our experience, for instance, in connection with the delisting of the securities on the exchanges, the managers, the insiders, or the board of directors, for some reason or other, may want the securities delisted from the securities exchange, and the Commission has no alternative but to grant that application, even though it may rebound to the detriment of the stockholders.

You may get a situation where there are acts of misfeasance in connection with the company which may require the delisting.

Now, the proposed recommendation of the Commission is that, in connection with any misfeasance by the officers or directors, the sanction shall be placed upon the individuals who are guilty of the misfeasance. Therefore we think it is essential, and that is why we propose in our recommendation that there be registration of those who are intimately tied up with the management of the company and intimately tied up with the distribution of their securities.

Now, another thing, Senator, and that is this: As we have emphasized repeatedly, you are dealing with a peculiar type of institution in the investment trusts. You are dealing with large liquid pools of the public's funds, which usually are gathered up on the theory that

people are expert managers who can manage these funds for the public, so that they would have the requisite safety for old age and so forth, as you heard from the literature we read this morning.

Section 9 says what? A person who is an officer, director, manager, or distributor should not be put in a position of having uncontrolled discretion with the management of other people's savings, if (1) he is a jailbird who has been convicted in connection with a securities fraud, or (2) if he has been subject to an injunction in connection with a securities fraud.

In addition to that, there may be situations where a person may have slipped and have been convicted. The bill does not make it incumbent upon the Commission or imperative or unconditional that the Commission shall refuse registration. The Commission, if it finds that it is not against the public interest or the protection of the investor, may allow such a person to organize an investment company.

The basic subject of this provision is that people who have been guilty of securities frauds ought not to be put in control of other people's money.

In subsection (b) on page 20 we said if a person has registered as an investment counselor under title 2, that registration is sufficient here.

Now, when I talk about people who have been convicted, of people who have been guilty of fraud, I am not speaking of imaginary things. We have had cases like that. One of the worst clean-outs was the Kenyon group of companies. A person who was at that time a fugitive from justice got control of them, turned them over to Kenyon, and cleaned up a million dollars.

Also, reference has been made to the *Continental Securities case* that Mr. Fulton described to you—I am not being facetious about this—because I talked with the people who were involved in this picture. The fellow who started that deal rolling was a fellow by the name of Espey. At the very time that Espey was working that thing out, the sheriff was looking for him. The way Frear and Ferretti described that situation, you would think it was the four Marx brothers. The marshal would come in one door and Espey would duck in the other room. When the marshal left he would come in the room again, and they drew up the papers there to accomplish that transaction.

This provision that this person would have to disclose his background and submit to the Commission that statement is provided so that the Commission can see whether he is the sort of person who ought to have control of other people's money.

Senator WAGNER. Did the marshal finally get him?

Mr. SCHENKER. No, Espey was not picked up, and I don't think he has been picked up yet.

Senator WAGNER. He is in the same class with those examples described by Mr. Healy, men who left the room and never came back again?

Mr. SCHENKER. That is right.

That is one function of the section.

Another function of the section is to make available to the investor a little of the background of these people who are going to manage their money.

The probabilities are that you will hear, when the industry discusses these provisions, that the effect of this provision will be that the only

ones you will be able to get to be the directors of investment companies, are messenger boys, and that type of individual. I do not want to be misunderstood. I am not disparaging people in the industry, but the fact of the matter is that when that statement is made they are not talking hypothetically; they are talking historically.

Take the *Continental Securities case*——

Senator TAFT (interposing). I do not know of any industry where directors and officers have to register. Isn't this something new in legislation?

Mr. SCHENKER. Well, Senator, you take under the Securities Exchange Act of 1934, section 15; every over-the-counter broker and dealer had to register, and it seemed to us, Senator, if Congress——

Senator TAFT (interposing). It says any officer, director, manager, or investment adviser. The banks are more important than these, and you do not require people to register to become managers of banks or presidents or vice presidents. If you are going to do it at all, should you not begin with banks?

Mr. SCHENKER. On that aspect, Senator, no banks, in my opinion, would put on the board of directors any individual who did not satisfy——

Senator TAFT (interposing). That is not answering my question at all. I am asking you whether there is any other industry in the world that requires registration for officers, directors, managers, and advisers of companies. Do you know of any such industry?

Mr. SCHENKER. Do I know of any other industry? No; Senator.

Senator WAGNER. Of course, it does not necessarily follow that because it has not been done in other industries it should not be done here, provided the abuses make that essential. That is a matter for us to decide in order to protect the public interest and the investors.

Mr. HEALY. May I interject a word there? The only basis upon which registration can be revoked or suspended are three: A person is not eligible to serve on an investment trust if he has been convicted by a court of competent jurisdiction of a fraud in connection with securities.

Senator TAFT. I do not think I would have any objection to such a provision. My objection is to this idea of registering people who are going into business. It seems to me that if you do it for investment trusts you ought to do it for every company in the United States, and then you get to the point where everybody is registered and everybody has to go to the Federal Government for permission to carry on business or to get a job, even.

Mr. HEALY. They do not have to get our permission, Senator, under this. The registration becomes effective almost automatically, and we can revoke it provided this person has been convicted of a crime involving securities—convicted by a court—or has been subjected to an injunction by a court.

Senator TAFT. Why have any registration? Why all of this red tape? This is regimentation, 100 percent. We are talking about regimentation perhaps when it is not justified, but it is regimentation when you say a man cannot engage in this industry as officer, director, manager, or investment adviser without a license. That is regimentation.

Mr. HEALY. That is not what it says. What it says is that he cannot manage these liquid pools of capital, contributed by small investors, if he has been convicted of a crime——

Senator TAFT (interposing). No; it says he shall not do it unless he registers with the Federal Government. If he has been convicted of a crime, all right, make it illegal for him to be a manager, although I think that is going pretty far. I don't even see why that should be held up to the public. A man may have been convicted early in his life and have been an honorable man for 20 years, and then he would be fired. Even that is going pretty far, but the important point is this new idea of requiring that a man be registered before he can get a job.

Mr. HEALY. I suppose you could have an express provision for a man convicted within 10 years that would prevent him from becoming an officer or director. If you had such a provision I think the very circumstance that you are speaking of would be legal. It seems to me that there may be cases, just as you indicated, where a man has been convicted within 10 years, where there are extenuating circumstances, where, nevertheless, it might be proper to let him act as an officer or director.

I think you will agree that, on the average, the presumption should be against such a man being put in charge of these large pools of liquid capital. That is all we are trying to accomplish there. Maybe the method is not the best that could be devised.

Senator TAFT. Well, it seems to me that if you had a complete inspection and publicity and required the companies to publish the names of their directors and managers, just as in the case of a bank, they are not going to employ anybody who has been in jail. There is no danger of it. If you have enough publicity about it, that seems to be the cure for it, not registration with the Federal Government.

Mr. HEALY. Of course, we have had instances where people have been in control of the investment trust despite the fact that they had unsavory criminal records.

Senator TAFT. You had a complete lack of publicity about investment trusts. You had an industry where there was no regulation and where undoubtedly a tremendous number of abuses arose, but I wonder if it would not be cured by inspection and regulation, rather than by registering everybody in the business and giving them complete control over all the details.

Mr. HEALY. You may be right. I would like to make this observation, however: that some of the worst things that have happened in this particular industry, due to the fact that men with unsavory records and few scruples got control of them, have happened since the Securities Act of 1933 was passed and the disclosure features were not sufficient to prevent their doing it.

Senator TAFT. Companies which had registered and had obtained a license?

Mr. HEALY. I can't say that they had actually registered, but I will point this out: That a company might at the time of this registration not have among its board or officers men with unsavory records, and those men might get control of it at a period subsequent to the registration.

In the case of the Kenyon Co. and the Continental Securities Co., as a matter of fact, I think some of those men came into those situations quite a time after their organization.

This seemed a flexible device to make provision so that that kind of man could not get into this kind of position, and yet make provision

for the companies where, despite that record, perhaps it would be all right to allow him to do it. At least, we have tried to explain the philosophy and the approach of this section of the bill.

Senator WAGNER. Of course, we have to consider that Senator Taft did not have the advantage of hearing all of these revelations before the committee. I have sat on many investigations, including the investigation of stock exchanges and banks, and I never heard of such outrageous exploitations of other people's money and the absolute looting of these investment trusts. I am speaking only of some of them. I know many men in the industry are men of high character and conduct their affairs in an honorable way. But this testimony shows that a large part of $3,000,000,000 lost—not their money, not the manipulators' money, but the people's money—has been taken from the people by looting. Although I am willing to hear suggestions from everybody, the industry and the legislators, I personally am convinced that this bill is a mild approach to protect the public's investments. I am not afraid of regimentation. I do not think this is. I think it is a very mild form of supervision to protect the American public. The testimony today, which I wish Senator Taft had listened to, of the methods used to secure the funds of truckmen, school teachers, domestics, and these absolutely outrageous misrepresentations made to them, which induced them to give up and lose their last pennies, has shown us a state of affairs which we cannot ignore. We have got to devise some means of protecting the people.

I am ready to receive suggestions and I am anxious to hear both from men as scholarly and as able as Senator Taft and other Senators here and also the industry. But I certainly won't sit still, as a representative of the people, and ignore these outrageous practices which, fortunately, have been exposed by the work of the S. E. C.

The other day Mr. Cook appeared here, and he represented Mr. Ballantine. We know him as one of our very distinguished lawyers in New York and a former Assistant Secretary. He is trustee and Mr. Cook is the attorney for the trustee in connection with the Continental Securities Co. They conceded that they could not have secured the evidence which is now being gathered to prosecute them. They said that without the aid and the investigation of the S. E. C. they could never have found this evidence. I think Mr. Fulton told us the same thing. They exposed these cases, and I feel that something has got to be done. I do not say that this is the perfect way to do it, but I do not think it is an effort at regimentation. It is an effort to protect the investing public.

Senator TAFT. I think it is the most radical possible approach to the question——

Senator WAGNER (interposing). That may be so, but——

Senator TAFT (interposing). Senator, you made a speech. Let me make a speech.

Senator WAGNER. Pardon me.

Senator TAFT. My suggestion is that the approach to the regulation of investment trusts should be the same as the approach to the regulation of banks, which incidentally, have far more money to handle for stockholders and depositors than investment trusts. I suggest that periodical published statements and examinations of the investment trusts' books by a corps of bank examiners whenever they chose to walk in would be simpler than the plan proposed here. This would

be sounder, I think, than the plan proposed here, handing over to the S. E. C. the regulation of the companies and their directors and officers. I do not question the need of regulation, not that these revelations show the most outrageous treatment of other people's money, nor that it has been revealed by the excellent work of the S. E. C.; I do not mean to question any of that at all.

Senator WAGNER. By the democratic process, that is the way we finally get to the solution of a problem.

Mr. SCHENKER. Section 9 (c), line 9, on page 21 provides:

> Except as hereinafter provided, such registration shall become effective thirty days after receipt of such application by the Commission, or within such shorter period of time as the Commission may determine.

Now, the mechanics we set up is this: a simple registration statement, under which we have registered 6,000 brokers and dealers, which became the backbone of the national association of brokers and dealers in this country.

Unless the Commission takes steps to revoke the registration—and the only ones are the grounds which the judge elaborated upon, and that the application itself contains untrue statements or does not state all the facts—that registration statement becomes effective. In addition, as the judge has indicated, even though he has been convicted within 10 years, if there were extenuating circumstances in connection with that, the Commission still does not have to revoke his registration statement.

Now, we felt that this approach would serve both those salutary purposes, and in all my discussion with the industry, Senator Taft, I do not think we heard any objection to this registration provision——

Senator TAFT (interposing). I think you will hear of it, because I have had two or three violent letters particularly about this provision that the application of every company—

> shall contain such information and documents in such form and such detail, as to such person and affiliated persons of such person as the Commission may by rules and regulations prescribe as necessary or appropriate to effectuate the purposes of this title.

That certainly gives the Commission power to ask anybody any kind of personal question about anything that he has ever done in his life, any property that he has, any money that he owes, and any securities that he owns. It requires a complete financial statement. It gives the Commission power absolutely to put anybody on the grill to any extent if he happens to be a director of any investment company.

Mr. HEALY. Of course, the provision to which I think the Senator refers limits the Commission's power to such methods as are necessary and appropriate to effect the purpose of the title. It seems to me that if we asked some of the questions you just mentioned we would be going far beyond the powers given us.

Senator TAFT. No; I do not admit that. I think this provision gives you enough power to make him give you a statement of everything he owns, everything he has ever owned, everything he owes, and everything he has ever owed.

Mr. HEALY. If it means as much as that, I would admit it is too broad. I do not think it means as much as that. If some additional language is necessary to indicate that, I am sure that there would be no objection to it.

Senator TAFT. Is "affiliated persons" defined? It does not include wives and relatives, I suppose?

Mr. HEALY. That is not included in the definition.

Senator TAFT. Is it defined somewhere?

Mr. HEALY. Yes.

May I also say that somewhat similar language is found in section 15 (b) of the Securities and Exchange Act, which requires application by brokers and dealers, and the forms that we have used for those applications do not go to the extent that the Senator has mentioned. We have never construed similar language to give us any such power. The administrative practice has been to restrict it to the precise duty that is imposed on the Commission by the statute. In other words, the administrative interpretation of a very similar provision has been much more restricted than the Senator has indicated.

Senator WAGNER. That type of inquiry is in line with the trend of legislation. I know in my time as State legislator we passed an act because of abuses in the real-estate brokerage fees or insurance broker fees. Men of disrepute got into that industry or that occupation and it was upon the suggestion of the industry itself, the brokers, that we passed this kind of legislation to protect them from these undesirable characters. As I remember, our language was broader than this; but I think the Senator has raised a question that if there was any chance of their having powers that were too broad, they ought to be narrowed to what was intended.

Mr. HEALY. Of course, you have the background of administrative interpretation of similar provisions, which I believe would be given some consideration if this were up for construction.

Senator TAFT. That is section 15 of the Securities and Exchange Act?

M. HEALY. 15 (b) of the Securities and Exchange Act.

Senator TAFT. That extends only, of course, to brokers and dealers themselves, and not to directors of companies?

Mr. HEALY. That is true. Of course, if you had a direct legislative prohibition against a person with this kind of record serving any one of these positions, you would still have left the task of discovering what persons had those records, which would involve inquiry on the part of someone.

Senator TAFT. Do you think you would discover another Musica if he desired not to be discovered?

Mr. HEALY. Senator, as to that case nothing seems impossible. A great novelist could not have imagined that.

Senator WAGNER. Well, I might say that about several of the cases you presented here. They sounded incredible, except that they were the truth.

All right, Mr. Schenker.

Mr. SCHENKER. Mr. Lawrence Meredith Clemson Smith is going to discuss section 10, which deals with affiliations involving conflicts of interest.

STATEMENT OF L. M. C. SMITH, ASSOCIATE COUNSEL, INVESTMENT TRUST STUDY

Senator WAGNER. Give your full name and position for the record.

Mr. SMITH. L. M. C. Smith. I am associate counsel, or have been

associate counsel, in the investment trust study over a period of several years.

I want to discuss section 10, which deals generally with the affiliation of persons with the companies and insofar as those persons have a pecuniary interest in the transactions of those companies. In section 10 we attempt to cover the people who would stand to gain or lose by what the investment trust does. Sometimes they stand to gain at the same time with the investment trust and sometimes they stand to gain in different ways.

Our record shows, at least as far as I am concerned, that some of the serious losses have come from people who have tried to carry water on both shoulders, whose integrity I do not attack, but who have tried to act in a dual capacity and serve their own interest at the same time that they have served the investment trust.

Mr. Fulton spoke the other day about the amateurs, whom you can always catch, but the thing that bothers me more is the person who says, "I can serve the investment trust and at the same time serve myself." That has been characteristic of a great many companies, particularly those organized by investment bankers and brokers, who have put in clauses which say they can deal with the investment trust without any responsibility except for gross negligence or fraud. It relieves them of any responsibility for their own errors except for gross negligence.

In some of these cases I do not attack the integrity of the people involved, but I do want to question the fairness of the transactions. Those situations become particularly acute when the investment company gets into large holdings of industrial companies or portfolio companies.

At that time, when you have the investment banker on the board and the investment banker is influenced in getting underwriting business or banking business, there becomes a very definite active conflict, as I see it, and we have case after case of that.

Now, the situation in regard to these people, such as the managers and brokers and people like that, becomes more acute in the case of the investment banker and also in the case of the commercial banker, and I would like to tell you the case of the commercial banker that I know of. That was a commercial bank up in New York State. At the time when it was merged with another investment company in 1929, it had about a million and a half dollars of loans outstanding, of which the major portion were loans to the commercial bank which had sponsored this investment company. In other words, the bank had bought out an affiliate security company, which was an investment company, and in 1929 it put a million and a half of loans out to officers and directors of that bank——

Senator TAFT (interposing). You mean the securities company loaned it to the directors of the bank?

Mr. SMITH. To the directors, president, and officers of the bank. I think those loans by 1931 amounted to $5,000,000 out of total assets of $9,000,000——

Senator TAFT (interposing). The investment company was not confined to dealing in those securities?

Mr. SMITH. They were engaged in all kinds of activities. These loans were used for trading in margin accounts, in the investment company stocks and in other stocks, by the officers and directors of that bank—I think there were 86 of them—and by 1935 those loans

still amounted to $3,400,000, and the collateral behind them was a few hundred thousand dollars. It is significant that little collateral was put up, the loans were not collateralized at all or had a different collateral standing from that of the bank loans.

In 1931, when the market had changed and it looked as if it was going up, the president of the bank and eight other directors started trading in the bank stock and they started an account called the Blakely account. Each one assumed liability for $200,000, making a total liability of $1,800,000. They started trading. The price of the bank stock went down and down, and by the time they stopped, I think it was the following February or March, the whole account was away under margin and they had not put up a cent of money—in other words, they were gambling with the investment company's money—and the president of that bank was not able to put up his $200,000 and neither was another director, and that company went through liquidation in 1934.

As an example, I had the president down here and he defended all the practices, and when I say I am afraid of the people who think they are acting in good faith, there is an example. He said these trading accounts were perfectly good investments, that the individuals were responsible individuals, that they did not need any collateral, and he admitted he had a different practice in the investment company than in the bank.

Senator TAFT. Who owned the stock in the investment company? The stockholders of the bank?

Mr. SMITH. The stockholders of the bank.

As I say, he defended these transactions and insisted that it was perfectly all right, although he admitted that in the bank whenever they took a loan they took collateral and had different standards. Also, the banking law provided that the particular persons could not borrow from the bank, but the investment company borrowed large sums from the bank and then the investment company loaned to these officers, so it was an indirect way of doing what they could not do directly.

These loans are still being liquidated. That man is still president of the bank. The directors are all in charge of the bank up there. A large amount of the indebtedness is still unpaid. They have put it into a separate bundle, so to speak, and the same people who are trying to collect the indebtedness are the ones who owe the money.

Senator WAGNER. Where did the $9,000,000 come from?

Mr. SMITH. The $9,000,000 came from investors all around that upper part of New York State.

Senator TAFT. I thought you said it was the bank stock.

Senator WAGNER. The common stock.

Mr. SMITH. Yes; the stockholders and the people who were depositors in the bank.

Senator TAFT. I thought you said it was a parallel distribution of the bank's stock.

Mr. SMITH. It was a parallel distribution of the bank's stock, also to the depositors of the bank. It was broader than that, because I know a case of another company who had a similar record up there There were a great number of Polish-American citizens involved, and they were threatening the lives of the officers.

Senator WAGNER. What did they get for their security? Common stock or other types of security?

Mr. SMITH. No; they got common stock.

Senator WAGNER. Were they voting?

Mr. SMITH. Yes; but there is quite a lot of concealment of what the actual facts were. They did not know. For instance, they took over about two or three other firms or investment companies and concealed all of these loans, and never disclosed them at all. The people who were merged that way paid a premium to get into this investment company associated with the bank.

There is another bank in that same city which had a similar experience with its officers; this was a case where an investment company was associated with a bank, and with parallel, interlocking officers, all the way through. On December 24, 1931, the loans to those officers and employees aggregated $744,000 out of one million nine of loans; and those accounts in turn caused the investment company to borrow from the bank. Finally, I think, this company got up as high as $31,000,000; and by 1936 or 1937, when we held the hearing, it was down to just $700,000 or so—a large portion of which was lost. Now, that is one type of situation.

Senator WAGNER. While you cannot call that looting, of course, and I would not characterize it as that, yet these practices should not be permitted; do you think so?

Mr. SMITH. Oh, no, sir. I do not think these practices should be permitted. These are all people who are now holding responsible positions as heads of these banks up there, and who claim to have acted in good faith. Perhaps they did; I am not trying to be too critical of the times.

Senator TAFT. And the stockholders have a perfect right to have them thrown out, although they lost money?

Mr. SMITH. And the stockholders have a perfect right to have them thrown out, if they can get them out.

Senator TAFT. And they were the ones who lost—the most active stockholders in the bank, who lost their money; and still they are satisfied?

Mr. SMITH. I think there is a long history to that, with respect to whether or not they are satisfied. You hear some of these people say, "Oh, our stockholders are satisfied," and the next morning we receive a letter from a stockholder in an investment company, saying, "I can't do anything; I am helpless."

Senator TAFT. Well, all individual stockholders are helpless, unless you can get an individual group of them together?

Mr. SMITH. That is right.

Then coming to the investment bankers, there is the instance of a company up in Boston that has been in business since 1873, I think. This case shows the change that can occur. It was an old, respectable banking house, and it brought out three investment companies. Twenty-five million dollars was raised, and a great deal of that money was put into security issues in which they were interested in one way or another; and $21,000,000 was lost.

Senator TAFT. Going back to the case you mentioned, I do not quite see why someone does not bring a suit against the gentlemen who loan money to themselves in that way—particularly when it is loaned without security. Would they not, under the common law, be subject to liability?

Mr. Smith. In the second case, sir, the suit was brought or threatened to be brought by a stockholder who had, let us say, paid $5,000 for his stock. They settled it with him and paid him off.

We have in this act a section about settlement of civil claims, and that is one of the situations to which that applies.

Senator Taft. In most places that I know of, the lawyer who collected it would then get a client and bring another suit.

Mr. Smith. They paid this man off, and I suppose it was understood that he would have to keep quiet.

Senator Wagner. However, it would be better to prevent it, rather than to have to bring suit.

Mr. Smith. That is right. The president of the bank said, "Mr. Smith, I am ashamed of having made this payment, and I should not have done it."

He admitted it, to the other stockholders who did not get paid off—that is, took the funds of one to pay another. It is my impression that it was a suit against the investment company.

Senator Taft. And not against the individual president or officer of the bank?

Mr. Smith. I am not clear on that point, sir.

Senator Wagner. You were speaking of this other case.

Mr. Smith. Yes; I am coming back to this case up in Boston. In that case you had an independent board; but at the operating level you had a man who dominated the whole picture. As I say, he was head of one of these old banking houses, and he brought out three investment trusts, one after another. Apparently he got into difficulties, because he borrowed money and had large sums borrowed, kept on deposit with the investment company. By 1931 he was insolvent; yet, after that insolvency, he took another million and a half from the investment company—I forget the exact amount.

He managed to stay alive until 1933 or 1934; there was segregation then; he had to get rid of his banking functions, and so he transferred the funds over to another account, as advances for the purchase of securities. Eventually all of that money was lost—about $3,000,000 which was advanced to this investment banking house. That is another type of risk.

Senator Wagner. How was it lost?

Mr. Smith. The money was lost by advancing it to him, and he dominated the investment companies, and borrowed the money and carried it on deposit or advance for securities to be purchased; and a lot of that was advanced after he was actually insolvent.

Senator Wagner. Do you mean he made a bad investment?

Mr. Smith. Oh, he used that for his personal interest.

Senator Taft. Do you mean embezzlement?

Mr. Smith. I would not go so far as that, sir; I think you have a very hard case to prove.

That is the difficulty of these situations. As I say, it is not the looting cases that bother me; it is where the individual investment broker says, "I can carry water on both shoulders."

I happen to be a trustee in several estates. I would not attempt to do it; and yet they say, "I can do it." They disregard the experience of years.

Then there is another case, where I do not attack the integrity of the people; but this investment company out in your State, Senator,

raised $116,000,000, and it dropped down to $16,000,000—I do not want to mention names, you understand.

Senator Taft. I think I know which one it is.

Mr. Smith. Yes, you probably know. It coincided; there is a purchase of $45,000,000 of securities—a purchase for cash or largely for cash—from a personal holding company which was dominated by this investment banker. That coincided with a demand for $12,000,000 from the New York Stock Exchange. He had to put up $12,000,000 additional. I do not know whether it is why he raised this money; I say these things happened at that time: This investment company bought $45,000,000 worth of securities from the personal holding company, putting up $35,000,000 in cash. In order to get the $35,000,000 it had to go to two big banks, and it was able to meet its requirements.

Senator Taft. The man who owned the holding company was a director or manager?

Mr. Smith. He was the dominating figure of the investment company, and in complete control of it.

Senator Taft. Was he the president of the investment company?

Mr. Smith. That is right. Now, sir, they denied there was any connection. Perhaps there was not; I do not know; but I just do not like it.

Senator Wagner. What happened to the money?

Mr. Smith. Well, what happened to it was that the investment company put up about $53,000,000 worth of securities to secure this $35,000,000 loan which was used to raise the cash; and then the banks foreclosed on that in 1933, and the investment company lost most of its assets.

As I say, it dropped from about $116,000,000 down to about $16,000,000 or $15,000,000, I think; and they went into receivership.

Senator Wagner. The $35,000,000 was lost in the speculation, I take it, or lost somewhere on the way?

Senator Taft. No.

Senator Wagner. What happened to it?

Senator Taft. They lost the difference between the collateral?

Mr. Smith. Yes.

Senator Hughes. They lost about $20,000,000?

Mr. Smith. Yes. It is very hard to make a positive statement and say that such and such a thing is a direct result of that, in dollars and cents.

That same investment company was involved in a number of steel mergers in which it used the funds to go around and try to merge two big steel companies, and got into the control of some rubber companies, and a lot of other industries. I do not know; perhaps those things are all right; but they coincided, also, with the interests of the investment bankers.

Senator Taft. Yes.

Mr. Smith. That problem, I say, creates difficulty—even with the people who are trying to act in good faith. We have numerous illustrations of what happens when they do not have the highest faith; but even with the people acting in good faith it creates difficulty.

Let me give you another example; this is a New York banking house: In 1929 this banking house was in control of two investment companies, and it decided to form a railroad account.

Senator Taft. The investment banking house?

Mr. Smith. An investment banking house which is in control of two investment companies, and quite large ones. So it started a so-called railroad account, to purchase $30,000,000 of railroad securities. The investment banking house did not put up any cash; all the cash came from the investment trust. They actually purchased about $15,000,000 worth of railroad securities.

Senator Taft. Who did?

Mr. Smith. This joint account which was conducted by the——

Senator Taft. The investment trusts?

Mr. Smith. The investment banker and the investment trust went into a joint operation to invest in railroad securities up to $30,000,000.

Senator Wagner. The same interests controlled both—the bank and the investment trust?

Mr. Smith. The investment banker controlled the investment trust.

Senator Wagner. Yes.

Mr. Smith. This New York investment banking house went into this joint account with the investment trust for $30,000,000, as I say. Actually, they spent only $15,000,000 to purchase railroad securities; but all the money was put up by the investment trust; all the $15,000,000 was put up by the investment trust, although the investment banker was responsible for a one-half interest. The investment banker, it is true, paid interest on that money, but it was lower than the existing call rates.

I examined the minute books in July, and I could find no record of authorization for this joint account until September. Then along came November 1929, and practically the entire portion of the investment banker was turned over to the investment trust, that is to say, turned over to the top investment trust; and then it found its way back again to the investment trust that was originally in the partnership.

So that with the crash and afterward with the hard times of 1929, the question immediately arose in my mind as to whether investment bankers do not need cash. I am not imputing any bad motives to this banker, but I say they need cash and they put this $7,000,000 worth of securities into the investment company.

Now, let me give you two of those situations: They had $5,500,000 in the Frisco and $5,500,000 in the Rock Island.

Senator Taft. They transferred the $5,500,000 at the then market price and not at what they bought them at originally?

Mr. Smith. Yes, at the then market prices; but in transactions of that sort there is always a question, and I asked this gentleman——

Senator Taft. A question of in whose interest it was?

Mr. Smith. Yes, and also whether the market prices were the criterion. In November 1929, Senator, you know what the market conditions were. Perhaps they should have gotten it at a discount; I do not know; but they had this big block in these two railroad companies. This investment banker is interested in underwriting, in a big way, and has done a great deal of underwriting; and there is a further history which indicates that they did get something of the underwriting of these railroads.

Eventually, both railroads went into receivership; and out of the 5½ million dollars invested in each railroad, I think the net realization was four or five hundred thousand dollars, or something like that.

In that case I do not want to attack the integrity of the investment

banker involved; but I say that that creates a great many difficulties, when the investment company is in partnership with somebody who is in the underwriting business, who cannot afford to have long-term investments, and who is interested in it.

The witness, on the stand, said, "We cannot afford to have long-term investments. We have to have short-term investments." The underwriter gets in and must get out again. He turns over his capital.

We have some figures, Judge Healy, which show that the average underwriter turned over his capital 15 times in 1 year. That is better than Macy's; Macy's turns over its investing about 10 times a year and that is rather fast for a retail store.

Senator WAGNER. Approximately how much was the loss in that transaction?

Mr. SMITH. About 90 percent, which would mean about $10,000,000 out of the $11,000,000 invested in these two railroads.

Senator TAFT. On the other hand, if the investment trust had invested $15,000,000, as you say it planned to do, it would have had the same loss, anyway; I mean the mere fact the loss occurred was the result of the fact that the stock went down.

Mr. SMITH. Yes; but the question arose——

Senator TAFT. I agree that there is a question as to whether they should have bought the second $7,500,000 at a time when stocks were going down, and so forth, and you cannot be sure they were not doing it to help the investment banker.

Mr. SMITH. That is right.

Senator TAFT. But as far as the actual loss was concerned, they might in the beginning perfectly properly have an investment of $15,000,000 in securities and lost 90 percent of it?

Mr. SMITH. They might, except there is always the further question of whether they went into these railroad securities——

Senator TAFT. To help the investment banker bolster up the prices?

Mr. SMITH. Well, to get underwriting business from these two railroads which were dominated by investment banking houses; and these investments amounted to about 3 or 4 percent of the stock.

Senator WAGNER. Those who controlled the investment trust were those who also controlled the investment bank?

Mr. SMITH. That is right; they had complete control of the stock.

Senator WAGNER. Where did that money come from? That is what I want to find out. Whose money was the $10,000,000 that was lost?

Mr. SMITH. That is the public's money that was contributed to these investment companies. We are here talking only about cases of investment companies that have sold their shares.

Senator HUGHES. It did not come from the bank?

Mr. SMITH. No.

Senator TAFT. The only thing I was trying to suggest is when it was suggested that there was a certain loss, as in all these cases, anybody who invested in anything would have had large losses, and it is hard to apportion the amount that would have been lost anyway simply because of market conditions and because of the trust or failure or lack of trust. You cannot say how much was one or how much was the other.

Mr. SMITH. That is right. That is the difficulty in dealing with people who are more or less high class. It is not a question of whether they loot them at all, but a question of how much of the profit belongs

to them, as opposed to the investment company, and who gets the good situation and how much the investment is worth, and things of that sort.

Senator WAGNER. Mr. Smith, exactly what is the abuse of which you complain here, in the particular instance that you mention, to show that there ought not be——

Mr. SMITH. I am trying to show that the relationship between investment trusts and investment bankers has difficulties; and it is that relationship which section 10 in part covers.

For instance, in connection with these railroads there is another investment trust that was involved in it; and a letter was written shortly after that time——

> He said that they expect to expand the syndicate for 3 months and he thought that Mr. Blank

This is the investment banker—

> would probably take up with the participants the question of a longer extension. He said their idea was not to cover an account by any given day but to continue to buy the stock as cheaply as possible, to accomplish the purposes of the syndicate and to keep "the other fellows from getting the road."

That meant the railroad.

Senator TAFT. The railroad?

Mr. SMITH. Yes; and there is quite a lot more of that.

Senator HUGHES. "The other fellows" were the two other investment trusts?

Senator TAFT. No; "the other fellows" were two other banks.

Mr. SMITH. There was another banking house that had another investment company which was also interested in the deal. So you get quite a few fingers in a pie like this.

Senator HUGHES. Yes.

Mr. SMITH. Then we have another big brokerage house which raised $25,000,000 in cash. Its history showed that $11,000,000 of securities were put into the trust in which they are interested. At the time when the stock exchange came along and demanded money more capital was put up, and they got indirectly a million and a half loan from the investment company, to cover the stock exchange examination; and then when their annual report went out, they shoved it back again; and then they took it out again.

That company went bad, and I think that $25,000,000 went down to about $3,000,000.

I can go on like this, with example after example of an investment company sponsoring a $5,000,000 investment company. You go down to November 4, 1929, and you find that on that day, which was one of the fateful days of November 1929 they were selling about $3,000,000 of securities to the investment company.

Senator TAFT. Which is the specific provision here which proposes to remedy this particular situation? Is it (a)?

Mr. SMITH. In section 10. You will see that we deal with it in various sections in section 10.

In section 10 (a) we say, first, that the majority of the board shall consist of people who are not members of any one firm. In other words, that is to avoid the type of situation like Eastern Utilities investing, which was dominated by Associated Gas in conjunction with investment bankers, and that company went from $77,000,000 down to $2,000,000 or $3,000,000 and went into receivership and was

used as an adjunct for the Associated Gas system. That is section 10 (a) (1).

Senator WAGNER. To provide a certain amount of independence in the operation of these investments?

Mr. SMITH. That is, at the board level.

Senator WAGNER. I am speaking of the board.

Mr. SMITH. Yes, sir. We approach this problem at the board of directors' level but also at the actual operating level, which is the official level, as I shall show you in 10 (d) in just a moment.

In subsection (a) (2) we say that the majority of the board shall not consist of persons who are pecuniarily interested in the investment company, such as the manager, investment adviser, broker, or principal underwriter or affiliated persons of such persons. We say that the majority of the board shall be independent of them, and we have got a number of investment companies in which that practice is followed and successfully followed. This is nothing new; I call your attention to the fact that the New York Stock Exchange, on April 22, 1931, came out with a statement as follows, re directorates:

> It has been urged that the public interest in investment trusts is entitled to adequate representation on directorates, and that such independent representation should be had through qualified individuals not directly affiliated either with the management of the trust itself or with its banking sponsors, if any.
>
> It is felt that, in default of such representation, the possibility of questionable transactions between investment trusts and their banking sponsors exists, and that this danger may lead to the feeling that investment trusts are not always managed with an eye single to the interests of their own stockholders.
>
> Against any such suspicion, investment trusts should be protected, and this protection will in the long run prove a benefit not only to the public but to the trusts themselves, and the banking houses with which they are at times identified.
>
> It appears to the committee as if such protection could be most readily obtained by independent directors under whose scrutiny and friendly criticism contemplated transactions would pass for review.
>
> This view will weigh with the committee in considering listing applications.

The investment code for bankers also recognizes the importance of an independent board.

Senator WAGNER. Mr. Smith, you have enumerated a number of instances where these transactions have occurred. Were any of them subsequent to 1929?

Mr. SMITH. Oh, yes.

Senator WAGNER. They are?

Mr. SMITH. Oh, yes; oh, yes.

Senator WAGNER. Those that you mentioned seem to have been in 1929, of course.

Mr. SMITH. Well, I started with them in 1929; but they continue on.

Senator WAGNER. These operations or similar operations occurred subsequent to that?

Mr. SMITH. Oh, yes; oh, yes.

Senator WAGNER. All right.

Mr. SMITH. But I suppose I got back to 1929 because that is the time when the majority of investment trusts were organized by investment bankers and brokers. Since that time there has been a reaction against them, and a large section of the industry has been organized saying, "We have nothing to do with investment bankers and brokers," because of that situation.

Just to show that this is not a fragmentary statement, I have some analyses of a large number of investment-banker-sponsored companies and broker-sponsored companies, in regard to loans to "insiders,"

repurchases from "insiders"—repurchases of their own securities—and sales of portfolio securities by "insiders" to investment companies; and in every case it tends to show a heavy concentration in the months of October, November, and December of 1929 and 1930. Now, that is a general statistical proof that these fellows go back to their investment companies when they need money. I do not say all those transactions are improper, but I say that a lot of them are very questionable.

You will notice that in dealing with this we have not at this time advocated complete segregation. Senator Taft was speaking about banks. My understanding is that investment bankers cannot be on the board of banks. Is that correct, sir? It is my understanding.

Senator TAFT. Yes; I have no objection up through (d) here. I have not read (e).

Mr. SMITH. Well, Senator, in 10 (d) we say that the same principles shall be carried down to the operating level, that the officer who is doing the actual determination of the decisions for purchasing and buying securities shall be independent, too, and shall not be one of these people who is receiving money out of the investment company in various ways, other than just its management.

Senator TAFT. What is the reason for the (c) provision, if they cannot?

Mr. SMITH. No, I am not there yet.

Senator TAFT. Oh, you have not yet gotten there.

Mr. SMITH. May I come back to that in just a moment, sir?

Senator TAFT. Yes; go ahead.

Mr. SMITH. In 10 (d) I want to point out one rather important investment company that illustrates the investment officer type of problem. There is a resolution from their minutes. It said:

> *Resolved*, That the authority conferred upon the president or either of the vice presidents to make purchases of securities for the account of the corporation up to the amount of $150,000 be and the same is hereby amended to increase that amount from $150,000 to $500,000.
>
> *Resolved*—and so forth, in another resolution giving the same authority to the president and vice president to give loans up to $500,000 instead of $150,000.

That is why I say a lot of these investment companies have a board of directors that meets every 2 or 3 weeks, if it does meet then, and they have an operating group that may consist of an investment committee or a single operating officer—like the man in Boston about whom I was speaking; he was the kingpin.

Se we make the same principle apply down at the operating level as with respect to the board.

Senator TAFT. Going back to (c) what is the reason that no director of one investment trust shall be the director of another?

Mr. SMITH. If he is an investment banker or broker.

Senator TAFT. Oh.

Mr. SMITH. I can show you some instances where investment bankers in 1929 were affiliated with four or five different investment trusts; and you will find that in one case in a fairly high-class firm; there was a 68-percent overlap with the other investment companies in the portfolio; and the portfolios are saturated with instances in which they are interested with investment bankers.

So we say the number affiliated with one investment company and not a lot of them, in order to avoid it.

Senator WAGNER. Mr. Smith, I was just going to try to qualify you as an expert. [Laughter.]

Mr. SMITH. Yes.

Senator WAGNER. As I understand it, you do manage trust funds now; do you not?

Mr. SMITH. I have been doing so since 1931.

Senator WAGNER. You have been managing trust funds of some size?

Mr. SMITH. That is right.

Senator TAFT. There is no overlapping prohibition against someone's being in the Securities and Exchange Commission and also managing investment trust funds?

Mr. SMITH. Maybe there should be. [Laughter.]

But I may say, from my personal point of view, I am interested in seeing this industry grow and not decrease, because I think it serves a very useful function.

Senator TAFT. That is so with all of us.

Mr. SMITH. But I cannot see how they can serve a useful function until they get cleaned up and stop trying to make their personal interests in the business of the company.

Senator HUGHES. May I interrupt you?

Mr. SMITH. Yes, sir.

Senator HUGHES. Do you see any means of cleaning it up, as you call it, except by regulation? The question arose this morning, and I have had some suggestion of the discussion as to whether some other plan might be adopted, other than regulation—that is to say, a statute forbidding certain practices; instead of regulating the company, simply shut it off so it could not any longer, without committing a crime, continue that sort of practice.

Mr. SMITH. Well, sir, we have as far as possible attempted here to put specific prohibitions into the statute, as opposed to leaving any flexibilities. I do not say we have done it every place, but I think you will find where we have not done it we have done it for the benefit of the industry; but I am in favor of as little administrative power as possible.

I might say the whole section 10 could be greatly cut down if you decide to segregate investment banks and brokers. I am not convinced that they should be segregated; but in view of the fact that 50 percent of the industry is sponsored by investment bankers and brokers, our recommendation has been this, instead of complete segregation which a great many people have recommended in our hearings.

Senator WAGNER. Which is much more drastic.

Mr. SMITH. Yes, sir; much more drastic.

Senator WAGNER. Yes, sir.

Mr. SMITH. In that respect I can show you various people in the industry who have appeared in our hearings, and otherwise, who have advocated complete segregation of the investment banker and commercial banks from investment companies; so that the position we take is a middle-road one between no regulation and complete segregation.

Senator TAFT. Yes.

Mr. SMITH. I do not know whether it is enough; I have doubts whether we should not go further. That is the only question I have.

Senator TAFT. But there is a question as to whether there is

certainly an advantage in having on the board a man who knows the business, if you can get rid of the personal conflict.

Mr. SMITH. That is right. On the other hand, sir, I do not think that the investment bankers or brokers have particularly shown their qualifications as managers. For instance, the investors' experience——

Senator TAFT. You are allowing only one director in a bunch of directors.

Mr. SMITH. That is right. I was going to say that, while in managing funds they have managed them about as well and no better than anybody else—that is, managing the funds after they got them—the investors' experience with funds run by investment bankers and brokers is the worst of all.

Senator HUGHES. What is that?

Mr. SMITH. I say the investors' experience. The experience of investors who put their money into banks operated by investment bankers and brokers is worse than any other group; and that is based on the observation of 82 companies.

Senator TAFT. And also based on the 1929 fiasco, when many of the people who went into those companies went into them as gamblers and knew they were gambling.

Mr. SMITH. Yes; but I think the investment bankers must have the responsibility for that; because they sold over $3,000,000 to the American public under those conditions.

Senator HUGHES. And on overloaned collateral.

Mr. SMITH. Yes.

Senator WAGNER. In these securities these stockholders do not have voting power, do they? Is not that controlled?

Mr. SMITH. That is another thing; we shall come to the devices for putting up very little money and getting the public's money and controlling. In that respect I would say the investment bankers must also share the responsibility; because I can show you company after company which has a complicated set-up which achieves that result and which from my point of view is undesirable.

Senator WAGNER. That is definitely a device, is it not?

Mr. SMITH. I think so.

Senator TAFT. What is the meaning of subsection (e) now?

Mr. SMITH. Now coming to (e), that is to prevent an investment company's having a director on the board of an industrial company which it owns in its portfolio: If it has a director on the board, there is always a problem as to whom he owes the duty. Does he owe it to the investment company or to the industrial company? I can give you an example of one of our leading companies, which is run by investment bankers, by the way, and which turned over in 1929 its commitment to take up some stock in a packing company. That investment company took up that stock, and had a $300,000 or $400,000 interest in the packing company. A banking firm also had a substantial interest of its own, and they had two directors on the board, interlocking directorates. Because the investment company was completely dominated by the banking firm and had nine members of the board, those were the only members of the board. Now, these two directors were both on the packing company and on the investment company, and sat on that company's board while it went steadily down, down, down, down; and finally in 1932, after some more money had been put up, it went into receivership. I questioned this director

who sat on both boards; I said, "How could you possible sell the securities of that company? You are a director and you owed an obligation to that company."

He said, "Oh, well, we would have done it."

Senator TAFT. I do not understand; I do not see that clearly.

Mr. SMITH. The investment company had interlocking directorates with this industrial company.

Senator TAFT. I understand that.

Mr. SMITH. And the investment company had a substantial investment in the stock of this industrial company, and also the banking firm; and they had interlocking directorates.

Senator TAFT. Do you mean the banking firm also had stock in the industrial company?

Mr. SMITH. Yes, that is right; they also had stock in the industrial company; but they had also done some underwriting for it, so there is a further mixture of interests.

This packing company went from bad to worse. Some people think the handwriting was on the wall.

Senator TAFT. Of course, many people held on to stocks when they went on down.

Mr. SMITH. That is correct.

Senator TAFT. I mean is there the suggestion that they concealed the condition of the industrial company?

Mr. SMITH. Oh, no; I am not questioning their integrity. I am just saying that having a director on the board in that case, he admitted, did not do the industrial company any good at all, and he admitted some of the conflicting loyalties that he owed to the industrial company and to the investment company.

Senator TAFT. Because a man sitting like that as a director would ordinarily pass on all the investments of the investment trust and also would keep them advised, of course.

Mr. SCHENKER. Senator Taft, may I give you an example with respect to this section?

Senator TAFT. First I should like to understand what you provide here. You are providing that it shall be unlawful for any director or officer of an investment company to serve as a director of an issuer of an outstanding security, that is, of an industrial company?

Mr. SMITH. That is right.

Senator TAFT (continuing). If the investment company owns less than 5 percent of the outstanding voting securities.

Why "less than five"? Why not more than five?

Mr. SMITH. Now, sir, in that respect we have said that if an investment company is going to hold less than 5 percent, it should be in a critical position. It should not be involved in the management of that company, but should be the investor and should look at that company from the investor's point of view and should have one hand in and out.

If it holds more than 5 percent, then we are drawing that arbitrary line—and there may be some other point where you should draw it: Then we have said that you can have a director but that director should not be an investment banker or broker.

Because when you hold more than 5 percent, or any large block of stock, and your investor is an investment banker or broker, you have all the danger of the use of an investment company for their purposes.

Senator TAFT. I do not understand. If you own but 6 percent of the stock of a company, then you can have a man on your board who runs that company; but if you own less than 5 percent, you cannot?

Mr. SCHENKER. Senator, perhaps I can explain it.

Senator TAFT. Yes.

Mr. SCHENKER. You were not present when we discussed the different types of companies. One type of company is called the diversified investment company, and that company invested in diversified securities without any attempt to exercise any control or influence in the portfolio of the corporation.

The other type of company is the company which says, "My business is to buy big blocks of stocks and participate in the portfolio"—like the Atlas, the Phoenix, or like the Continental, in Ohio.

We say that if the type of company is the diversified investment company which is limited to holding not more than 5 percent of the outstanding, he should be in the position of a critical investor, without any obligation to the portfolio corporation, which he may have if he is a member of the portfolio corporation.

Senator TAFT. The result is that unless they happen to be one of these big operating ones, no investment company could have as a director or officer any director or officer of a stock listed on the New York Stock Exchange?

Mr. SCHENKER. That is correct, sir.

Senator TAFT. Is not that rather an extreme viewpoint? I mean the first few provisions seem to be based on the theory that if you have an independent manager you are all right.

Now, you come along and say, "You shall not have even one man"—a General Electric officer; Mr. Swope, perhaps—"on the board of an investment trust if you are ever going to invest in any investment securities except more than 5 percent."

Of course, it is unlikely that you could.

Mr. SMITH. This is from the manager of a company that raised $7,000,000 and had about $1,900,000 left on April 30, 1932. He sold the company out:

> I was anxious to find some way to improve the position of the stockholders and I had made up my mind that under our set-up we could not operate as efficiently as under a set-up where there was one man in control. My experience and observation has been that it is very difficult to get half a dozen men to agree at the right time to purchase or sell securities where each one has practically equal authority in your corporation. If I would suggest I thought it was time to liquidate they would say, "Yes; we think you are right. Conditions don't look very good." "Well, what will we sell?" Then we would go on down the list, and my experience was each director seemed to have some company and he said, "The others can go down, but this is going to stay because I know all about it and we won't sell it." So it became a very difficult and unwieldy problem to manage it.

Now, Senator, this interlocking director about whom I told you before said that in 1 year they had four complaints about the investment company selling their stock, that he as a director should have prevented the investment company from selling the stock of the company of which he was a director, and he was an interlocking director.

It may be that this first provision, section (e) (1), needs some rubber in it. I do not know, but I think I have tried to make clear the principle of it.

Senator TAFT. And section No. (2)?

Mr. SMITH. Section No. (2) is directed at the investment banker.

Senator TAFT. That would apply only where the man occupied three positions, really—as an investment banker, as an industrial director, and as an investment-trust director?

Mr. SMITH. That is right.

Senator TAFT. So that is not such a prohibitory one. No. (1) is the more restricted?

Mr. SCHENKER. Senator Taft, may I give you an illustration—and I am going to use the name of the company, because the witness testified and practically said we could use his name.

You take the Central Illinois Bank, of Chicago. That was the Dawes bank, and Henry Dawes graciously came down and testified, as did Mr. Philip Clarke, who was the president at that time. They had the interlocking situation of the officers and directors of the bank appointed officers and directors of their investment trust. What happened? The bank stock was declining. The officers and directors of the bank, who were also the officers and directors of the investment trust, used the investment funds to try to stabilize the bank stock because they were afraid of a run. Here was Mr. Clarke on the board of directors of the bank and on the board of directors of the investment company; and, as I said, to Mr. Clarke, "Mr. Clarke, when you were there with the finest inside information in the world, you were on the board of directors of the bank and you know that application had been made to the Reconstruction Finance Corporation for $90,000,000, and yet you permitted your investment company to stay with a block of stock of the bank of $2,000,000, with the possibility of assessment for double liability?"

He said, "Mr. Schenker, I could not open my mouth. I could not tell the investment trust to get out of that block of stock. And if I suggested that the investment trust liquidate the bank stock, that would have accentuated the difficulty to the bank and the possible danger to the trust, and I had to sit there and eventually permit them to lose $2,000,000."

Senator TAFT. It is exactly what an outsider would have done? The difficulty of which you are complaining is not that, but that the majority of the whole trust is controlled by the bank?

Mr. SCHENKER. That is right.

Senator TAFT. You are stating a case here where you are prohibiting even one director, the stock of whose company may be owned in part in a long portfolio of an investment company.

Mr. SCHENKER. That is correct, Senator.

Senator TAFT. I mean I do not see, in the particular case you cite, where they were any worse off by having Clarke on the board; and in many other cases he may have known many things about other Chicago companies which would have been most valuable to the investment trust and where he would not have been limited.

Mr. SCHENKER. That is right; but if the investment trust had not been affiliated with the bank and had that information, there would have been nothing to prevent them from selling the stock; but because Philip Clarke was a director of the bank, he could not make that suggestion.

Senator TAFT. It would not have been of any use in that situation, but would it have been of any particular harm?

Senator WAGNER. The entire amount was lost?

Mr. SCHENKER. Yes, the entire amount.

Senator WAGNER. If he had not been on the board, he could have prevented their losing part of the stock?

Senator TAFT. If he had been some outsider, he could not have made the suggestion to keep them from losing the stock because he would not have known.

Senator WAGNER. That may be; but I would think it would be better if the entire board were free of any kind of influence from bankers; because I think you can get other men. Of course, I know that is ideal and that we are not going to get that far; but then there would be no chance about their loyalty being consciously or subconsciously only to their investment trust rather than to outside interests.

Mr. HEALY. Does it not come down to the question of what the basic philosophy of the investment trust shall be? That is, shall the diversified trust which goes into diversified iindustries and invests small amounts in each one take any responsibility for the management of the companies in which it invests or shall it take a stand-off, critical position of those investments?

Senator TAFT. Look at it in another way: I happen to know of the trust fund of the Cincinnati Institute of Fine Arts. We want to get the best executive committee to invest. Whom do we get? We get the president of one bank in Cincinnati and we get the president of another bank, and we get the vice president of Procter & Gamble Co.—why? Because we think those men will know more about what we should invest in than anyone else. That is the only way in which an investment trust would be run. So you have a balance of desirability; and up to (d) I have no criticism of it. I question a little bit (d) (1); it seems to me that may be going a little far.

Mr. HEALY. May I add a word to what I was saying? When you get out of diversification which I mentioned and you get an investment trust owning a portion of the underlying portfolio of the corporation, above a certain amount, then this does not apply.

Senator TAFT. Although the question of dishonesty then becomes of much greater weight than in just under 5 percent.

Mr. HEALY. Yes; but in that kind of position it can be argued that the company is taking responsibility to some extent at least for the management of the corporation in which it invests.

Senator WAGNER. I still say there should be complete separation, and that in the long run it will serve the better purpose. However——

Mr. SMITH. I shall run quickly over these other sections, Senator.

Senator WAGNER. All right.

Mr. SMITH. Now, Senator, (f) is to take care of the investment-banker situation. If they have more than one-half of 1 percent in the portfolio of the investment company, then an affiliated person cannot do the underwriting. That is to prevent the investment trust's being used, so to speak, as a bird dog for the investment banker; and we have various cases where the investment trust was used to get brokerage or all the other emoluments that the investment broker looks for or, once he has them, it may be used to put them in cold storage for him. I can give you other illustrations of companies affiliated with investment bankers, where 30 percent or 40 percent of the portfolio has been securities which they have underwritten; and there is one investment company today which has run and has a pretty good record with investment bankers. But I have questions about it, myself—not as to the integrity but as to the policy. When they are in less than one-half of 1 percent situations, of course, that is different.

But where their big, major holdings are in this category, then I do have questions—where, out of 60 major holdings, 25 percent of those major holdings are situations in which they have gotten underwriting business. Now, whether or not the investment company was used for that purpose I do not know. In the hearing we held, it was admitted that it was of some help to the investment banker.

I do not think the average investor should be subjected to that risk. It has been disastrous, with a person who is a little bit unscrupulous; and even to the best person it requires the wisdom of Solomon, it seems to me.

In section (g) we say that no registered company shall purchase any security until a year after it has been put out by an investment banker. In other words, they should not buy the product of the investment banker, even though they do not buy directly, to stimulate the market for it, until the security has been seasoned for a year.

Senator TAFT. That applies only when a director is a member of the underwriter?

Mr. SMITH. That is right.

Section (h) is a reciprocal arrangement provision to prevent evasion of the arrangement.

Section (i) applies to a specific type of company. That is an exception just to make these sections applicable to them.

Mr. HEALY. Senator, I have to get back to the Commission to make a quorum.

Senator WAGNER. Yes; I think it is time to stop for today, at any rate. We have been at this all day.

I am glad you came.

Senator TAFT. I have been in the Senate Appropriations Committee meeting all the time.

Senator WAGNER. Yes; I know the Senator is also busy there.

Mr. SMITH. May I say, also in the record, that these trustee activities of mine are wholly family matters. I am not in any other business.

Senator WAGNER. Have you not gotten along without interlocking directors?

Mr. SMITH. I have gotten along very well. As a matter of fact, the standards set up in this act do not come up to the standards I have to carry out and set for myself; and I have some question about that, myself.

Senator WAGNER. Yes. Well, gentlemen, we shall adjourn at this time until tomorrow morning at 10:30, then.

(Thereupon, at 4:50 p. m., an adjournment was taken until tomorrow, Tuesday, April 9, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

TUESDAY, APRIL 9, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, Miller, Frazier, and Taft.

Senator Wagner. The subcommittee will proceed with its hearing. Mr. Schenker, you may resume your statement.

STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, SECURITIES AND EXCHANGE COMMISSION, INVESTMENT TRUST STUDY, WASHINGTON, D. C.—Resumed

Mr. Schenker. We have reached section 11, on page 27 of the bill, which deals with the subject "Recurrent Promotion of Investment Companies."

You will recall Mr. Stern's description of the growth of the Founders System where, in rapid succession they organized investment trust after investment trust. The Founders picture was not a rare or unusual one.

Our study indicates, or at least we have the feeling which, in our opinion, is substantiated by the record, that in a great many instances the formation of investment companies is not predicated upon any inherent belief in the soundness of the particular company which is organized, but rather is generated for the purpose of having merchandise which the distributor can sell.

When you have that close association between an investment company and distributor—and the distributors do engage primarily in the distribution of investment-company securities and have tremendous selling organizations—after a particular company loses its sales appeal it is almost incumbent upon them to start organizing another investment company so they may have more merchandise to sell.

The basic philosophy of section 11 is that the investment-company industry—and "industry" is a most unfortunate word, because it is not an industry but it is like a savings bank—is not a device merely for creating securities which people can peddle.

Now, in connection with that let me just give some indication of the extent to which this practice of recurrent promotion of investment companies can be carried. We find that one of the companies engaged primarily in distribution of investment-company securities, organized

from 1924 to 1932, 12 investment trusts. In one year alone that distributing agency was responsible for the promotion of 1, 2, 3, 4, 5, 6 investment trusts.

Senator WAGNER. Do you mean in 1 year?

Mr. SCHENKER. In 1 year there were six investment trusts, management investment trusts as contradistinguished from the fixed trust, because you may get the argument in the case of the fixed trust that there is no management involved—it is just a package of securities deposited with a bank, and an interest in that fixed trust is sold to the public. But I am now talking about management investment companies.

Senator FRAZIER. Do you mean that was done at one and the same time?

Mr. SCHENKER. Within a year. Practically every 2 months a new investment company was brought out by that distributor.

Senator WAGNER. By the same group, do you mean?

Mr. SCHENKER. By the same—shall I say, individual? He was in the business of distributing investment-company securities.

Senator FRAZIER. If they are doing an honest business what is the excuse for organizing all these different investment companies? Why not one company instead of a dozen companies?

Mr. SCHENKER. That is precisely the attitude of the Commission on that subject. We say that if one is really in the investment company business as an instrumentality of furnishing expert management and advice to the small investor, and is interested in managing the money and in being compensated by management fees, then he ought to be able to form one company, raise money, and devote all of his time and effort to the management of that company; that he should not be in the slightest motivated in the formation of these investment companies by the profits he may make through the sale or peddling of securities.

Now, that is not the only situation. Then you have another company which was in the business of selling investment company securities, and they organized one, two, three, four, five fixed trusts, and then within 2 years organized one, two, three management investment companies.

Don't you see, Senator, at a certain point in the development of these institutions the major portion of the profits may be in the distribution of securities rather than in the management fees one gets, because when they sell those securities they get a sales load, and with these big distributing agencies they have to keep generating merchandise to sell.

Now, let me give you an example: Only recently an individual came to me and said—and he was associated with one of the investment trusts—he wanted to organize another investment trust. I said, "What kind of trust are you going to organize?" He said "Well, my salesmen tell me that the kind of investment company they can sell is the investment company where the investor gets a check regularly." Now, such a man is not interested in where that check comes from, whether that check really represents dividends or earnings. The investor will find it difficult to distinguish between a case where he is getting earnings and where he is getting a part of his money back. This man was going to set up such a trust where an investor would be getting 9 percent on his money. I said to the man, "You know you cannot earn 9 percent; in fact, you cannot earn

6 percent, because our statistical analysis shows that the ordinary income such an institution can earn is usually about 2½ to 3 percent." He said, "I know that, Mr. Schenker." I then said, "Well, why?" He said, "What I will do is this, I will pay it out of earnings if there are earnings, out of capital gains if there are capital gains; and if there are no earnings or capital gains I will pay it out of service." I said, "What will you charge?" He said, "I will have that 9-percent load, and I will have one-half of 1 percent in management fees on the total assets." I said, "It seems to me the only thing you are doing is charging the public a 9-percent load and you have the one-half of 1 percent management fee, and you are giving the investor back his own money in drips and drops."

After we threatened to stop the proceedings he fixed up the prospectus a little bit, and today he is selling the securities of that investment company.

Now, aside from the rapid formation of these companies, one after another—and you can see, Senator, that these people do not make any substantial investment in these investment companies. In an extreme case all one needs, is a lawyer and $125 to get articles of incorporation in Delaware, a couple of salesmen to start out peddling. He gets money from the public, and he gets management fees and distribution fees.

Now, aside from that you have this problem: They organize one investment trust. The security of that investment trust loses its sales appeal. Thereupon they organize another investment trust, and what do they do? Then they start switching from one investment trust to another, and our record indicates—and if the members of the subcommittee are interested, they will find it on page 214 of our report on fixed and semifixed investment trusts—that there were as many as six switches from one to another.

On page 215 of the report you will find where we had one case where there was an investment trust organized and there was an exchange on November 5, 1931. Then another trust was organized and there was an exchange in 1934; then another one was organized, and they were switched into an open-end company.

We say fundamentally this business is a business of furnishing management advice to small investors. In our opinion the only way you can stop this business of putting the emphasis on distribution and running the whole investment trust with an eye to distribution, is to say that you cannot, any time you want, organize an investment, trust.

Senator, one cannot organize bank after bank; one cannot organize insurance company after insurance company, and we feel they should not be allowed to organize investment trust after investment trust.

Now, section 11 of the bill says what? If you organize one investment trust, then within the period of 5 years you should not be allowed to organize another investment trust if you are going to be the manager of the new investment trust.

Now, we concede that the 5-year period is an arbitrary period, but we also have the feeling, from our study, that within 5 years a man ought to be able to get up for himself a sufficient pool to make it pay him to run it. If you have any shorter period, then you are going to get a recurrence of what happened in 1932, 1933, 1934, and 1935; and you are going to get a recurrence of what happened in the case of these fixed trusts with all the switching.

Now, there is nothing arbitrary about this because we say: There may be instances where there may not be any undesirable aspects to a person organizing more than one investment trust. You may get situations because of the tax situation or other circumstances, where an individual may have liquidated one trust, or severed his connection with one trust, and he may want to organize another trust.

Then we say what? In subsection (d) of section 11 we say: In such a situation if he can make out a case that he ought to be permitted to organize another investment trust, then the Commission shall by order, conditionally or unconditionally, exempt the promoter from the prohibitions of this section (d). We try to set forth in some detail the things the Commission should consider in passing upon such an application.

Now, if I may take one more moment on that: You take the Goldman Sachs Trading Corporation. Goldman Sachs was sold to the public in December of 1928, and they raised $100,000,000. Within a short period of time Goldman Sachs Trading Corporation arranged for a merger with Financial & Industrial Securities Corporation another investment trust, which had $117,000,000 of assets.

Now, this may be of interest and it is a little aside: The Goldman Sachs Trading Corporation stock was selling on the New York Curb Exchange for $135 a share, 30 percent above its asset value. Financial & Industrial Corporation stock was selling at $140 a share although its asset value was $70 a share. Thus the stock of Financial & Industrial Corporation was selling at a one hundred percent premium. What happened? On February 4, 1929, the Goldman Sachs Trading Corporation started buying in its own stock on the New York Curb, and, Senator, within a period of 4 days what do you think was the dollar amount of stock bought back of the Goldman Sachs Trading Corporation?

Senator Wagner. Do you mean of its own stock?

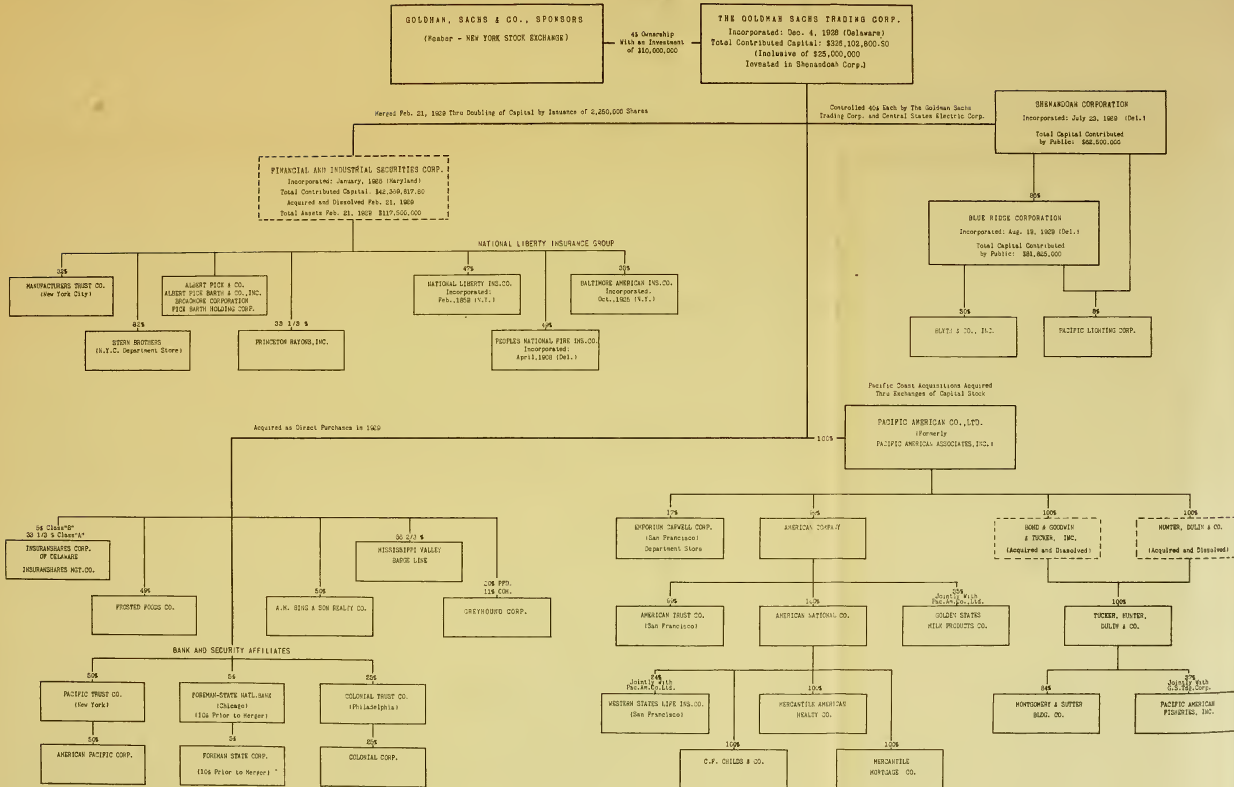
Mr. Schenker. Yes. It bought back $46,000,000 of its own stock, pushed the price up from $135 to $220, and was buying back its own stock at $220 when its asset value was $110, thereby paying $110 a share premium for its own management. Well, they had to do it to make that exchange. Financial & Industrial Securities Corporation stock had a market of $222 while Goldman Sachs Trading Corporation stock at a market of a hundred and ten, although their asset values were the same.

You have the Goldman Sachs Trading Corporation with $234,000,000. Within a few months, on July 23, 1929, they organized the Shenandoah Corporation and raised $62,500,000 of the public's money in that corporation; and then, shortly after that, in August of 1929 they organized the Blue Ridge Corporation and got $81,825,000 from the public.

Senator Wagner. Is this all the same group?

Mr. Schenker. This is Goldman Sachs & Co., organizing the Goldman Sachs Trading Corporation, and then Shenandoah and Blue Ridge. I think there was a joint sponsor in the latter situations. Then they arranged for an exchange of Goldman Sachs Trading Corporation with one of the biggest bank holding companies on the Pacific coast, so that by September of 1929 the Goldman Sachs Trading Corporation had raised $326,000,000.

THE GOLDMAN SACHS TRADING CORPORATION
1929



What did they have in 1932? $33,000,000, and in our opinion, Senator, a good part of that loss was of course attributable to the stock market decline, but another part of that loss was because they had such large funds to invest. What was the result? This was the result: This chart, which I would like to introduce in evidence——

Senator WAGNER (chairman of the subcommittee). That may be made a part of the record.

(The chart entitled "The Goldman Sachs Trading Corporation" is made a part of the record.)

Senator WAGNER (chairman of the subcommittee). You may proceed, Mr. Schenker.

Mr. SCHENKER. This chart is the result. In their prospectus what do you think they said the nature of their business was going to be? To trade in securities. What did they wind up with? They wound up with a 32 percent interest in the Manufacturers Trust Co., upon which they lost in 1932 and 1933 $70,000,000. They wound up with a 49 percent interest in Frosted Foods, which cost them $13,000,000 and which they lost almost completely. They wound up with insurance companies and banks and promotional adventures.

If you will take a look at this, and I consider this a matter of some importance, and Mr. Waddill Catchings who was in charge of that corporation denied this; but if you will look at this picture, what do you find? They had the investment trust buy institutions which were big purchasers of securities, banks, and insurance companies.

Now, Goldman, Sachs & Co. had been bankers for a great many industrial companies, but they had never been bankers for any public utilities. Well, we find that suddenly they put up a large sum of money to build a Mississippi barge line. You also find that they accumulated, or had the investment company acquire, some of the largest distributing agencies for securities throughout this country, and one of the largest wire houses throughout this country. You will find that they took a half interest in the company which was going to build properties in New York.

You may say that is fantastic, but you have a case where the Goldman Sachs Trading Corporation may have been using the funds of the public essentially to help Goldman Sachs & Co's. banking business.

One of the investments they made, or that they had the trust make, was in the Greyhound Corporation, a bus company. In the files we find this letter, which they furnished to us. After the analyst describes the investment as a very speculative one, we find this paragraph:

> The connection with the company should prove valuable in other ways. In the first place if the industry develops as it gives promise of doing the contact should prove of material value to Goldman Sachs & Co.

You do not see any statement to the effect that the contacts should be of value to the investment trust:

> With the expected stabilizing of the industry, the connection should give rise to financing opportunities. In the future the Motor Transit Corporation [the original name of Greyhound Corporation] may be expected to require capital for additional expansion, the simplification of its present capital structure, and the possible acquisition of a larger interest in the two western holding companies.

Now, that is all that section 11 of the bill says. Section 11 says that these are institutions in which the public puts their savings to receive diversification and expert management. That is the primary

purpose; the distribution aspects should be secondary. The distribution aspect should not be the primary thing that motivates the formation of these companies.

Now, we go on to section 12——

Senator TAFT. I do not see what basis there is for saying that having organized one, he cannot organize another. I can see why we might prohibit an investment banker from having an interest in an investment trust; but after he once promotes it and is through with it, why should he not go on the next year and promote another one? What has Goldman-Sachs got to do with it?

Mr. SCHENKER. That was just an illustration, Senator, of the rapidity with which these things were formed. I asked Mr. Sidney Weinberg, a partner of Goldman, Sachs & Co., "Why do you form them so rapidly?" He said, "Well, the people want them."

You were probably not here, Senator, when I started the discussion in which I said that if we permit this constantly recurring promotion, the thing that might motivate constant promotion of these companies is not any inherent belief in the economic soundness of the set-up generally, but a desire to manufacture merchandise which may have sales appeal at the moment.

Senator TAFT. That is the object of all promotion in this country. That is the way we got ahead—by promotion. That statement assumes that promotion, in and of itself, is a bad thing. I do not see why, admitting that it is perfectly proper, possibly, to prohibit anybody from promoting a certain kind of investment company, after he promotes it and starts it on its way, I do not see why he could not start another one next year, if he is out of the first one. I do not see what that story has to do with this particular section which you are discussing, except to stir up prejudice.

Mr. SCHENKER. Oh, well, Senator Taft, after all, Congress directed us to make a study——

Senator TAFT. No; I am objecting to your using this to support this section with which it has no relation.

Mr. SCHENKER. The fact of the matter is, Senator, that it appears to me that it has relation, because here you have Goldman-Sachs & Co., bankers——

Senator TAFT. Your whole argument is directed to the one question of an investment company not having an interest in an investment trust, with which I wholly agree; but I do not see what it has to do with section 11 (a) which you are discussing.

Mr. SCHENKER. Well, on section 11 (a), Senator, our study indicates that when an individual has a distributing organization with a tremendous overhead, the impulse may be to create these companies in rapid succession, not with any inherent belief in the economic soundness of the type of company he is creating, but because that particular institution has sales appeal. I illustrated that with an example where a person had one, and his salesmen told him they could sell the type——

Senator TAFT. That has nothing to do with section 11 (a). I want to know why, if a man has promoted an investment trust one year, he should not promote another one next year.

Senator WAGNER. Are they dissociated?

Senator TAFT. They may be.

Senator WAGNER. That is what I want to find out from the instance given.

Mr. SCHENKER. Section 11 (a) says (reading):

It shall be unlawful for any promoter of a registered investment company organized on or after March 1, 1940, to serve or act as director, officer, manager, investment adviser, depositor, trustee, or principal underwriter of or for such company, if within 5 years such person, or any company of which such person was then an affiliated person, has been a promoter of another investment company.

Senator TAFT. I say, he may have entirely dissociated himself and has no relation with it any longer, and for 5 years after that time he can not promote another one.

Mr. SCHENKER. The bill does not say that. If you will take a look at paragraph (d), you will find that we make provision to permit other promotions if conditions warrant such promotions. But aside from the provision for exemption—you were not here, Senator, when I gave examples where there were six investment companies promoted in 1 year by one distributor, and in conjunction with that they switched them from one investment company into the other investment company.

Senator TAFT. Those cases were cases in which they kept their hands on all of them. I can see the whole burden of that. But after he has entirely gotten out of one, why can he not start another one?

Mr. SCHENKER. Is it your suggestion, if he is in the business of promoting investment trusts, distributing their securities, and then severing his connection with the investment trust, why should he not be able to promote another?

Senator TAFT. Yes.

Mr. SCHENKER. Would you have any difficulty, Senator, if he not only was promoting one trust and currently organizes another, and sells securities of the other, and then starts another and sells the securities of that other—would you have any difficulty with that situation?

Senator TAFT. Well, if he has entirely dissociated himself, I do not see why he should not promote another one. We agree that there is some question about the whole matter of promotion.

Mr. SCHENKER. I am not unconscious, Senator, of the fact that this is a question that has two sides. We have discussed it at great length. The fact of the matter is that the situation which you describe never exists. I think I know of only one case where that was done. In all these cases, Senator, he not only promotes it; he is not only the distributor, but he is the manager, and as soon as the security loses its "sex appeal," he starts organizing another one.

Senator TAFT. Why not say "any company of which such person has been a promoter of another investment company of which he is a stockholder, director, officer, manager"——

Mr. SCHENKER (interrupting). Or distributor?

Senator TAFT. Yes; then my objection would be removed.

Mr. HEALY. May I have an opportunity to discuss that with my associates?

Senator WAGNER. Yes.

Senator MILLER. Would it be feasible to incorporate in subsection (d), page 28, terms or provisions which would determine or which should guide the Commission in answering a question propounded to it when a group or an individual came to it for a license to organize another investment company, or is the theory the same as that govern-

ing charters for national banks and other banks that are organized now? As I remember the statute relating to the creation of a bank, the mere fact that a group wants to organize a bank is not the determining factor. The needs of the community are determined, and the character of the men proposing to organize the bank. I was just wondering, in order to get away, if I can, from so much discretion now—and this is not said with any reflection upon the present Securities and Exchange Commission—just assuming that the personnel of that Commission were changed and a different philosophy entirely should be installed there, and I was just wondering if there might not be some danger in a wide open discretion and whether or not it is feasible to undertake to limit the discretion of the Securities and Exchange Commission.

Mr. HEALY. May I say a word on that?

Senator MILLER. Certainly.

Mr. HEALY. I do not think the Commission wants unlimited or unbridled discretion. Our conception is that every one of these statutes should have definite standards in them. But there are situations where those standards ought to be administered, it seems to us, by the Commission. I think that unbridled and uncontrolled discretion is unthinkable under our constitutional system. I think that every time it is said that the Commission can do a certain thing, it should be allowed to do it if a certain standard is established. Then you get a legal standard and get a thing that is reviewable in the courts and the Commission is deciding people's legal rights.

As to this subsection (d), if more definite standards can be written than the draftsmen of this bill have devised, they would be entirely acceptable.

Senator MILLER. That is not said from a critical standpoint. It is just a proposition of trying to lay down some standard there to guide not only the Commission, but the officers. In other words, I can visualize, and I know that the Commission can, a group that has made a success, that is basically sound; that is, their company is basically sound. Those men ought not to be prevented, and I do not assume that the Commission's theory is that it would prevent those men, from organizing another business and branching out.

Mr. HEALY. I have much sympathy with what you have said. May I call your attention to the fact that subsection (d) was written assuming that (a), (b), and (c) might be enacted——

Senator MILLER. That is, subsections (a), (b), and (c)?

Mr. HEALY. Yes; subsection (d) represents "rubber" in the language. That is, having adopted rigid standards in (a), (b), and (c), then you try to give the Commission authority to relieve a person of the undefinable and unpredictable case, at the same time trying to specify in the statute the circumstances to which you shall give weight in making your decision.

However, I would like to repeat that any more definite standards that can be devised, or any other means that would give a little flexibility where it is needed. I would not have the slightest objection to.

Senator MILLER. I did not think you would have any objection to a reasonable standard in there if it can be devised.

Mr. HEALY. No. I am all for it.

Mr. SCHENKER. Section 12 deals with the functions of investment companies and the formation of investment-company systems.

This bill, in my opinion, cannot even remotely be considered as an attempt to influence or participate in the management policy of investment companies. What does 12 (a) say? It says that it shall be unlawful for any registered investment company to purchase any security on margin or credit except such short-term credits, necessary for the clearance of transactions, as the Commission may designate by rules and regulations or order.

Subsection (2) is a provision which says they shall not participate in joint trading accounts.

Subsection (3) relates to the effecting of a short sale of any security in contravention of such rules and regulations as the Commission may prescribe.

The Commission has the feeling that at the present time, at least, they see no reason why an investment trust should not be able to effect a short sale. However, you cannot predict what may happen in the future. With respect to that the Commission feels that maybe at some time in the future, in the public interest, it may be necessary to formulate rules.

Senator Taft. You mean that you are permitting short sales?

Mr. Schenker. Yes.

Senator Taft. Why? What is the purpose? Is it not rather questionable whether they should engage in short selling?

Mr. Schenker. On that aspect, Senator, we make provision for a so-called trading corporation. If they are going to be a speculative investment trust, and they disclose that fact to their investors, and the investors want to invest in that type of investment company, who are we to say, "No; you shall not invest in that type of company"? So the statute permits it, and we feel that, if they are that type of company, why should they not sell short if that is their best investment judgment?

However, there may be some possibility of abuse. In that connection I started to say that a person came in to see me the other day and said, "I am thinking of organizing a short-selling trust." What that means, I don't know, or what its effect will be I don't know. But it is to meet that type of situation that we put this "rubber" in.

Senator Taft. I think that if you distinguish between the two types of companies there is no harm in an investment trust making short sales. On the other hand, if the other kind of investment trust is supposed to do it, I see no reason why it should not be done.

Mr. Healy. That is exactly the philosophy with which the Commission approaches this problem.

Senator Taft. No; it is not. The approach is that the Commission is going to say in the future whether either kind of company shall do it or shall not do it.

Mr. Healy. I did not speak of our approach. I said that was the Commission's philosophy. I meant to say that the point of view that I have heard expressed in the Commission is just the one which you have expressed.

Senator Taft. We are all trying to get away from the discretion question.

Senator Wagner. I agree with that, but as I studied this bill I thought that the discretionary powers were rather to the advantage of the company than to its disadvantage. It does provide flexibility, whereas a fixed rule would make it much more rigid.

I was going to ask you this, Mr. Schenker. There has been talk here about the promotion of investment trusts. So far as any instances that have been cited here are concerned, as I understood it, in each case those who organized a trust and distributed shares represented it not to be any trust to promote any new risk venture, but rather to provide a diversified investment for the individual, with assurances in all these cases that it is a safe investment with a very definite maturity and a sure return of the money with profit.

Mr. SCHENKER. I think you may have misunderstood Senator Taft's point, which merits consideration. Senator Taft says that if an individual promotes a company and distributes it and severs every connection with the company, why should he not be able to promote another and to sever his connection with that? Of course the answer to that, Senator, is that such a situation has not existed. But of course I think there is a great deal to that point in that type of situation.

Senator WAGNER. You misunderstood me. I do not know of a single instance where there has been any advertising that "We want this money in order to undertake a venture, some new venture," or something of that kind. Are there any such trusts formed?

Mr. SCHENKER. There have been trusts in the past, which started out originally as so-called diversified investment companies. They said they were going to buy a cross section of securities. But ultimately the fundamental nature of their business changed, and they became what we call special situation companies. They took concentrated positions in companies, reorganized them, worked them out to help them financially. The classic example of that was the Atlas Corporation, which had a $20,000,000 position in the Utilities Power & Light. The Phoenix Securities Corporation, which I told you about, has a substantial position in the United Cigar Stores, Loft, Inc.; Pepsi-Cola; New England Bus Co.; Autocar; and Southwest Corporation. Recently the Chicago Corporation has started to change the fundamental nature of its business and is attempting to serve a very useful function in making capital available to small industries. But in those circumstances, because the securities they get are not liquid and have no market, they necessarily have to take a controlling position to protect their investment.

Senator WAGNER. I do not see any objection to that method of changing their activities; but should not the stockholders who originally put their money in under certain definite assurances, know about that change of policy?

Mr. SCHENKER. That is the approach of this bill, Senator; and when we come to section 13, which deals with changes in fundamental policy, I will elaborate upon that.

Senator TAFT. Were there not always a fair number of trusts that frankly went in as trading companies? It seems to me that I remember several small ones in Cincinnati which frankly said, "We can trade on the market better than you can, and you might as well let us do it."

Mr. SCHENKER. Yes.

Senator TAFT. I remember one or two of that kind.

Mr. SCHENKER. I do not think you were here, Senator Taft, when we discussed the classifications of investment companies. This bill does not say that that type of company should not exist. It just says,

"Tell your stockholders that that is the type of company you are going into, and if they want to speculate on the New York Stock Exchange, that is all right with us."

May I go on?

Senator TAFT. Certainly.

Mr. SCHENKER. Now, we come to paragraph (4) of section 12 (a), and that substantially says that an investment trust cannot act as a dealer in or distributor of its own securities in contravention of such rules and regulations as the Commission may prescribe.

What is the significance of that? By far in the great majority of cases the distribution of the securities is not undertaken by the trust itself, but is undertaken by independent distributors who make a business of distributing securities. There are some situations in which investment trusts act as their own distributors of their own securities. There is a type like that of Scudder, Stevens & Clark, which does not have a sales load——

Senator TAFT. Scudder, Stevens & Clark are not brokers, are they?

Mr. SCHENKER. No. They are investment counsel.

Senator TAFT. They are not investment bankers?

Mr. SCHENKER. No. To my mind, Senator, that may be a model situation, because you take a bank which has trust funds, they do advertising, but they do not have salesmen who go around trying to sell participations in trust funds to the public. However, I am not unmindful of the fact that there is a differentiation between those two types of situations. We do not want to discourage that type of distribution where they do not have salesmen.

Where do Scudder, Stevens & Clark get their investors? A person comes into their office and he has $25,000. They will not take anybody who has less than $150,000 to $250,000. They say, "We can't give you a personalized investment service. Why don't you buy an interest in our investment company?"

So their expansion is through that medium rather than through the employment of salesmen.

We do not want to discourage that type of situation.

Senator TAFT. Let me ask this question. Paragraph (4) of section 12 (a) provides (reading):

to act as a dealer in or distributor of securities of which it is the issuer.

They cannot be a registered investment company. The trust shall not act as a dealer in or distributor of securities of which it is the issuer. That is, its own securities?

Mr. SCHENKER. Yes.

Senator TAFT. As for me, I think I would be willing to prohibit entirely dealing in its own securities, unless there may be some time an obligation to buy back. The common law originally provided that a company could not buy its own securities. It cannot in Ohio, and it seems to me that that was a good rule, but it has been changed in a lot of statutes.

Mr. SCHENKER. In England and Australia today a company cannot buy back its own securities, and therefore all the investment companies in England and Australia cannot. We have a specific section which deals with that.

Senator TAFT. What is the reason for allowing it at all?

Mr. SCHENKER. It is only, Senator, to cover the type of situation like that of Scudder, Stevens & Clark. I have been in pretty close

contact with pretty much all the investment counselors of repute in this country. They are all confronted with people of moderate means who want their service and cannot get it. The investment company is really an adjunct to their investment counsel business, so that they can give a type of investment advice to people of moderate means, comparatively, although not exactly the same as they can give to people in the higher brackets. I do not see why it should be discouraged.

Senator TAFT. I am saying, Why should they have a right to buy their own stocks? That always gives somebody the discretion to soak the rest of the stockholders and let one fellow out without letting the others out.

Mr. SCHENKER. The repurchase of a company's own stock is not a simple problem. We have given it a great deal of thought.

When will an investment company buy back its own stock? It will buy back its own stock when it is selling at a discount, that is, when the market value of the stock is below the asset value. So that every time they buy back their own stock they make a profit. It is true that this discount accrues to the benefit of the remaining stockholders, but you have this fundamental problem which has been disturbing the industry, and frankly, they tell me they do not know the answer.

To whom is the primary obligation of the management of an investment company? Is it to the individual who is remaining with the corporation, in which event the stock must be bought at the cheapest price? Or do we have some obligation to the fellow who turned his funds over to us to manage and who wants to get out for some reason?

So you find these companies in that dilemma. Why do they buy back their own stock? In some respects, Senator, it serves a function in that, by virtue of their purchasing power, they may be paying the stockholder who wants to leave the company a little higher price than he would be getting ordinarily. Of course it has been urged also that in case of distressed markets the buying of their own stocks has a stabilizing influence on the market price of such stocks.

As we visualize the problem, what has occurred in the past, Senator, unfortunately, is this. It is true that this bill provides that a director or officer or manager cannot sell back his holdings in the investment company. But that is a matter of each circumvention. All he does is to sell them on the New York Stock Exchange or the open market, and the investment trust will buy back his shares.

Senator TAFT. My inclination is to prohibit it altogether, and I am raising the question whether or not it should be entirely prohibited. It has always seemed to me a doubtful thing.

Mr. SCHENKER. There is much to be said for that feeling.

Senator TAFT. If they can find another purchaser, all right. If they cannot, it is a pretty good reason why the stockholders should not buy it back.

Mr. SCHENKER. Our approach has been, Senator, that if the company is going to cut down the size of its fund by acquiring its own stock, then every stockholder in the company should have a right to pro rata reduce his interest in the fund. Therefore our approach is that it be done through the form of tenders—"We are prepared to buy back our own stock." Therefore everybody, officers, managers, directors, the small investors, will have a right to sell back to the

company their aliquot share of their stock interest in the company.

But we will elaborate on that a little bit when we come to it, Senator.

Now, subsection (b) on page 29, in substance says that a diversified investment company can do underwriting, provided the maximum amount of underwriting it does is in the 15 percent reservoir.

On that aspect, Senator, while we were defining different types of investment companies, we made provision for the creation of a class known as the diversified investment company, and, as the name signifies, the emphasis is placed on diversification and investment as distinguished from trading.

In order to make available part of the funds of the diversified investment company to industry we said that with respect to 15 percent of your assets you can go into underwritings. If they feel they can make money by furnishing capital to industry they can do it up to the extent of 15 percent of their total assets.

When we get above that, Judge Healy and the Commission had the feeling that underwriting is an entirely different business from investment. It is more speculative, and if you permit a greater diversification than 15 percent, you are subjecting people to the risks of the underwriting business.

Subsection (c) says that it is unlawful for any registered investment company to purchase or otherwise acquire any security issued by, or any other interest in the business of another investment company.

That is a flat prohibition. In the future no investment company shall buy the securities of another investment company, with this exception. You may meet situations where you have a small fund; the management is not doing a job, and it wants to relieve itself of liability. At that particular moment, if there were no liquid assets, or because of the depressed condition of the market which might then prevail, it might be an injustice to these people to liquidate the trust at that time.

The exception is for the type of situation where one company is going to take over another investment company and make it one unit. It makes provision for the situation where one company may want to consolidate with another company. But we will discuss those provisions later.

I think this ought to be made clear. This section does not say that in every situation at the present time where one investment company owns another it is incumbent upon them to dispose of their interest in the other investment company, or that they collapse the structure and become a single unit. Pyramided structures of investment company systems in existence at the present time are not touched.

There was a great deal of sentiment for cleaning up that type of situation, and if you will bear with me one moment I will just show you what the possibilities are and I will try very succinctly to illustrate some of the abuses that have been created by virtue of that.

Senator TAFT. I would be inclined to agree with the bill on that, myself. I do not see any reason for pyramiding them.

Senator WAGNER. There are others of us, you know. We may want to know something about it.

Mr. SCHENKER. I want to show you what is possible, Senator, when you permit that. If you will look at the top of this exhibit [indicating] you will see what the set-up was in the first instance. I thought it was an Ohio company, but it was a Detroit, Mich., company. They were first set up really as separate and distinct corporations. Each one was organized separately. In 1930 you find two separate companies, having no connection with each other, and then one being pyramided on the other. The following year you have one separate company, and then one top company owning two of the others. In 1932, the following year, they had the arrangement set forth. In 1933 they began a complete circle, the American Capital Corporation owning the Pacific Southern Investors, Inc., which, in turn, owned Investment Company of America, which, in turn, had an interest in the American Capital Corporation.

Then the following year the circle straightened out and went into a straight line. In 1935 it took a different puzzle effect, and in 1936 it has taken another puzzle effect.

Senator WAGNER. Can you tell us the reason for all of these organizations? You investigated this matter, did you not?

Mr. SCHENKER. Oh, certainly. The reason is that by doing this you can solidify your control of the particular situation. They could control the one company. And it has not been unusual, as we have shown, that they buy control, in the first instance, by using borrowed money and reimburse themselves out of the assets of the investment company by selling out dubious securities. They also buy management stock. There is one case where $30,000,000 of the public's money was raised and the management stock was sold for 50 cents a share, for $200,000 to insiders.

In that particular instance the management sold its management stock for a very substantial amount, and control was turned over to somebody else. They get control over part of the management stock, and take the investment trust funds and buy the common stocks of other companies which have money belonging only to senior security holders, and in that way they can build up a very substantial pool of public funds which they control at little or no investment by themselves.

I thought you might be interested in taking a look at the Central States, which is the company that Mr. Harrison Williams controls. This is approximately at the present time—December 1939.

In this situation you see Central States Electric Corporation has assets of $13,000,000. It has got outstanding 5 percent convertible debentures due in 1948; 5½ percent convertible debentures due in 1954; 7 percent preferred stock; preferred option dividend series, convertible preferred stock, and common stock. That company is superimposed on other investment companies which also have bank loans. It is a complicated capital structure, Senator. Not only do you have pyramiding, but you notice that the Central States Electric Corporation has a 31 percent interest in Blue Ridge Corporation. The Blue Ridge has an 8 percent interest in Central States Electric Corporation. You find that the Central States Electric Corporation has a 7 percent interest in General Shareholding Corporation, and General Shareholding Corporation has a 3 percent interest in Central States Electric Corporation.

Senator TAFT. Are these five all operating companies?

Mr. SCHENKER. That [indicating on chart] is the holding company itself.

Senator TAFT. The others are just an investment trust?

Mr. SCHENKER. Yes. What is the effect of that, Senator? Their principal investment is in the North American Co. You are not only pyramiding capital structures, but you are pyramiding the management fees. I do not want to appear brusque, Senator, but it seems to me that a situation like this just does not make sense.

And not only that, Senator, but take a look at the Central States Electric Corporation. Mr. Williams' original investment in this situation, as I recall it, was $3,000,000. By pyramiding investment company on investment company and operating pools in all the underlying investment companies, in the course of the general market increase, his shares of stock, after he got back his original investment and dividends, reached a market price of $687,000,000.

Senator WAGNER. As the result of what?

Mr. SCHENKER. Of course that is leverage—putting leverage upon leverage upon leverage. October 1929 rolled around, and as I recall it, he sold about $45,000,000 on the way down, and his interest was worth $27,000,000.

The curious thing is this: That at the time when his stock was worth $687,000,000, he indirectly controlled a utility system with a billion dollars of assets. Today, the stock has no asset value at all, it is practically all under water. If you will notice, the Central States Electric Corporation, with assets of $13,000,000, has $26,000,000 of debentures outstanding. The debentures are only worth 50 cents on the dollar, and the preferred stock is under water. But Mr. Williams today has an influence in a utility system worth $3,000,000,000.

That is one of the major problems in connection with investment companies.

Senator TAFT. Is the common stock in the hands of the public?

Mr. SCHENKER. The common stock in Central States is mostly owned by Mr. Williams. The public owns the senior securities, the debentures, and the preferred stock.

Senator WAGNER. How much did the public put into this investment, approximately? The larger share, of course?

Mr. SCHENKER. $250,000,000 of the public's money went into the whole system.

Senator WAGNER. When that money was sought what were the representations that were made as to what was to be done?

Mr. SCHENKER. The usual representations that he was going to invest it in utility stocks.

Senator TAFT. When they went into this, how did they come out?

Mr. SCHENKER. If they got out before October 1929, they did very, very well. If they stayed along with him, they did not come out very well.

Senator TAFT. How was Mr. Williams making all his money out of common stock without the other people making some?

Mr. SCHENKER. He at that time owned 90 percent of the total outstanding common stock of Central States. He did not know the fancy word "leverage." He had been in the bicycle business, and he is a most charming and interesting man. He figured out that if he issued senior securities he would have the finest margin account in the world. The debenture holder puts up the money and is

entitled only to the return of his principal and interest, which corresponds to what the broker is entitled to in a brokerage firm. He had this big pool of money of the public with which he could speculate.

Of course if you are under water and your margin account is at the broker's, you will get a telephone call to put up margin; but no matter how much Mr. Williams is under water in the Central States, nobody can call on him to put up more margin.

That is one of the things that motivated us in putting a provision in the bill that somewhere along the line there ought to be an equitable distribution of voting power.

The people who really own Central States Electric Corporation have actually no voice in it. The income of the company is not sufficient to meet the interest requirements on debentures. Mr. Williams is gradually liquidating that company by selling its portfolio securities to meet interest payments, and the debenture holders are really getting their own money back.

Senator TAFT. He will lose everything he has in Central States if he liquidates.

Mr. SCHENKER. If he should liquidate that company today he would not get a dime out of it. Yet he is running that company and has some influence in this utility empire.

That is one situation which we felt merited consideration, and that is one of the reasons why we put in this provision about the redistribution of voting stocks. These debentures do not have any touch-off clause. They can go down to nothing.

Senator FRAZIER. Have no what?

Mr. SCHENKER. Touch-off clause. Usually a debenture has a provision that if the assets go below a certain percentage of the total amount of the debentures outstanding, then there is a default and the debenture holders can take the company.

I say, that is one of the numerous instances that persuaded us to make provision that the persons who really own the company, at least ought to have a vote in some instances.

Now, what can be the result? What do we mean by this high leverage stock? By "leveraged" we mean that phenomenon which, when the total assets of the company increase a certain amount, the asset value of the common stock increases in a greater proportion, because all of the increase, after a certain point, goes to the common stock.

What is the effect of that? I am not saying this about Mr. Harrison Williams, because I have never met a more gracious and cooperative man in my life. I examined him for days. He was very helpful. But the only way he can make any money, or a person in a similar situation, is to take speculative ventures, because if he can make a profit in the first instance, the profit will accrue to the greatest extent to the common stock. To whom does he owe the primary obligation? Every time he makes an investment, you have got to ask the question, Is it good for the common stock holder——

Senator TAFT (interposing). I do not quite get the point. What you are now saying is that in an investment trust the preferred stock holder should have more voice in the management? There is no management stock; this whole 10,000,000 shares of stock—common stock—has voting power?

Mr. SCHENKER. That is right, Senator.

Senator TAFT. I mean, what is your suggestion as to the remedy for the situation?

Mr. SCHENKER. The remedy is, Senator, not a simple matter, and because of the complex nature of the problem, we could not make specific provision for that in the statute. For instance, if the preferred stock passes its dividends twice, the preferred stock holder should have a vote, and if the common stock has had no asset value, the preferred stock holder can say, "You are gambling with my money. I should have something to say with respect to my investment."

The debenture holders may have said, "Mr. Harrison Williams, you have had use of our money for many years. You could have made millions. Don't you think we should have some representation in the management?"

We have a section in the bill which says something about that. I have a little difficulty with the language, but the underlying philosophy is that there comes a time when the person who owns the stock should have something to say in the management of it. That is the whole purpose of the section which says that there should be an equitable redistribution of voting power. That is one of them.

The other one is where a person gives himself stock at 50 cents a share and raises $30,000,000 from the public. The whole industry says that should be abolished, but the fact of the matter is that such type of stock is outstanding. It is not in the hands of the person to whom it was originally issued, but has been transferred from person to person. You have the situation where the public has millions of dollars in that picture, and the people who have the management stock have the majority vote in that situation.

Senator TAFT. Of course, if the company has not enough assets to equal the debentures, then it is insolvent.

Mr. SCHENKER. That is just the point.

Senator TAFT. Does that not make it insolvent?

Mr. SCHENKER. No; that is the peculiar nature of an investment company. If you are an industrial company you have a plant, you have equipment, you have service, you have help, and many charges that you must meet. An investment trust, and I am not being facetious, is nothing but a safe deposit box. It has practically no expenses. It can cut its expenses down to nothing. You can reduce an investment trust to nothing and not be insolvent. You may be insolvent, but I do not think you are committing an act of bankruptcy.

Senator TAFT. Oh, that is different.

Mr. SCHENKER. Yes; I am sorry.

Senator TAFT. I do not see why any investment trust which is insolvent should not be thrown into the hands of a receiver, just like a bank. My general approach is that they should be treated like banks and if, on a periodic examination, it is found to be insolvent, appoint an examiner and take it over and then liquidate it or not, whichever seems to be desirable. Of course, that would not be true of preferred stock. You still have the preferred stock question.

Senator WAGNER. There is no attempt, however, to limit the kind of securities that an investment trust may take. I suppose that will come next. I was going to ask you this question, perhaps because of ignorance on my part. Where is the conflict between the common stock and the debentures? For instance, the common stock does not get any dividend or profit until after the debentures have been cared for and the fixed payments made.

Mr. SCHENKER. That is right.

Senator WAGNER. So is it not to the interest of those who control the particular enterprise?

Mr. SCHENKER. I think I can explain that with a simple little illustration. I think it is important, because when we come to the capital structure section, you will see some of the reasons which motivated the Commission to say that in the future these investment companies, like a bank, should have one class of stock.

Senator WAGNER. I was asking the question as to what the conflict was.

Mr. SCHENKER. As I say, to follow through the analogy to a brokerage account, if you opened up a brokerage account with a broker, you put up the required amount and he puts in whatever is necessary. If the stock you buy in your account goes sky high, the broker does not get any part of the profit. The only thing he gets back is the advance to you and the interest. Isn't that true?

Senator WAGNER. Yes.

Mr. SCHENKER. If you visualize the senior security holder in the same capacity as the broker, then what is the situation? All the profit that the company makes accrues to the common stock holder. You find this situation. Suppose you had $100,000 of debentures outstanding and you had $100,000 of common stock outstanding. That gives you total assets of $200,000.

Now, the total assets increase $300,000, which makes your total assets $300,000. None of that $100,000 increase went to the debenture holders except in the form of interest. That means that the entire $100,000 was divided equally among the common shares which were outstanding. In a situation like that if the total assets increase 33⅓ percent the asset value of the common stock increases 100 percent.

Do you see what I mean?

Senator TAFT. In other words, the more you speculate, the more the benefit goes to the common stock holder. If you lose, the common-stock holder loses, too, but so does the other person, and he has not had a chance to make a cent. Their interest, in other words, is different.

Mr. SCHENKER. Yes.

Senator WAGNER. You mean if you sell your stock you get the profit; if you hold your stock you do not get the benefit of it?

Mr. SCHENKER. Temporarily you have got a greater value. If you do not go out and the stock market goes against you, the value will decline.

Senator WAGNER. If the enterprise makes profit, you first pay your fixed charges.

Mr. SCHENKER. That is right.

Senator WAGNER. If there is anything left that goes as dividends to the common-stock holder?

Mr. SCHENKER. That is right.

Senator WAGNER. So it seems to me that the management in control of the common stock should be interested in making profits for the enterprise. There is no conflict there, because they get their profits or their dividends only after the fixed charges are paid.

Mr. SCHENKER. That is right.

Senator WAGNER. You say, "That is right," but where is the conflict? There is a conflict if you are speculating.

Mr. HEALY. The impulse on the common stock is to speculate to get profits on the capital structure. That is the worst policy for the security holders.

Senator WAGNER. I understand, but somebody must have to buy that stock, if you are speculating with it, and there may be sufficient of it sold so that the control changes.

Mr. HEALY. Yes, but while I hold the stock I may get dividends on it after the interest has been paid.

Senator WAGNER. Exactly. There is no conflict there, is there?

Mr. HEALY. Sometimes the welfare of the senior security holders and the junior are in quite opposite directions.

Senator WAGNER. Well, I do not understand your explanation.

Mr. HEALY. We have instances here where it seems quite clear that the investment policy or the speculative policy of the trust was wholly in the interest of the common stock and not in the interest of the senior security holders. They were led into extremely speculative channels, which were good for the common stock and not good for the senior security holder.

Senator WAGNER. I may be able to clear it up in my mind by asking this question: As the value of the common stock increases, it increases because the enterprise is profitable, and if the interprise is profitable, then there is a dividend due after fixed charges are paid; is that not true?

Mr. HEALY. Yes, sir.

Senator WAGNER. Now, where is the conflict there?

Mr. HEALY. They are not always profitable.

Senator WAGNER. Do the stocks go up even though they are not profitable?

Mr. SCHENKER. No, Senator.

Senator WAGNER. All right, proceed.

Mr. SCHENKER. Section 12 (c) (2) merely states that an investment company cannot buy an interest in a brokerage firm, a distributing company, or an investment banking house. It goes further and says that if it is engaged in the underwriting business itself—if engaged in that business through a wholly owned subsidiary—it is permissible to do so.

You can see the reason for that. They may not want to subject all the assets of the investment trust to the risks of the underwriting business. So we see no difficulty if they avail themselves of the corporate fiction and limit their liabilities to the amount of money they want to invest, so we say, "If you want to go into the underwriting business and want to do it through the wholly owned subsidiary, there is no difficulty with that situation."

Section 13, I think, we have elaborated upon, and that is the section which deals with the changes in the fundamental policy of the company. I do not think the industry does or can have any conflict with that approach. There may be some question, however, with respect to the sentence which says:

> The Commission, by rules and regulations or order, shall designate those investment and management policies which are fundamental, giving due weight, among other things, to the representations made in selling the outstanding securities.

and various other things.

Now, why was provision made for rules and regulations? If you would stop at the sentence, "No registered investment company shall

change any fundamental investment or management policy unless each such change is authorized by the vote of a majority of its outstanding voting securities," you would have this situation. A management may say, "Well, I am going into the commodity business. Is that a fundamental change?"

The second sentence makes it incumbent upon the Commission to tell them what a fundamental change of policy is, so that he does not act at his own risk and peril. He is apprised specifically what is a fundamental change of policy and what is not a fundamental change of policy. Then you relieve him from the danger of guessing "Am I changing the fundamental policy or am I not changing the fundamental policy?"

Frankly, as far as I am concerned and as far as Judge Healy is concerned, if the committee wants to take a blue pencil and cross out that sentence which says that the Commission shall tell these people what is a fundamental policy and what is not a fundamental policy, that is all right with us.

Then you leave them in this predicament: He wants to go into the commodity business. He wants to buy foreign paper. He wants to do a little discount business. Then he has the problem of determining the answer to the question, "Am I changing the fundamental policy or am I not?"

This provision does not tell him what he can't or can do. This provision says, "If you want to change from A to B, you can do it." This section does not say he cannot do it. The only thing he has to do is tell his stockholders and say, "Please take notice. I am going to change my fundamental policy, and because I am going to change my fundamental policy, I have got to have your approval."

The only effect of that situation is that we will assume the burden of saying whether or not this is a fundamental policy, which will immediately relieve the management of that trouble and annoyance.

As I say, if the industry has difficulty with it, you can just blue pencil it out.

Of course, the committee must be conscious of the fact that we have a provision in section 36 (c), on page 78, which says this:

> No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or order of the Commission, notwithstanding that such rule, regulation, or order may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

Now, that provision is a duplicate of what is in all the securities and exchange acts, and it really, in substance, requires willfulness and intent. If you act in good faith and if you violate a rule or regulation, there is no liability.

Senator Wagner. May I ask a question there about something I want to understand? You speak of fundamental policy. Now, how do you ascertain what the fundamental policy was? Do you go to the charter and the limitations there, or how do you ascertain what the fundamental policy was that was being pursued by the investment trust, and whether it is being modified or changed?

Mr. Schenker. Now, the fact is, Senator, that it is provided in our registration provision, section 8, that he has to say, "I am a diversified investment company."

Senator WAGNER. Exactly. That is what I want to know. You go back to the registration?

Mr. SCHENKER. That is right.

Senator WAGNER. To ascertain what the fundamental policy was.

Mr. SCHENKER. But in determining whether there is a change in fundamental policy, the Commission has to give consideration—it cannot be arbitrary—to these specific things which are enumerated in section 13 (b).

Now, we come to section 14——

Senator WAGNER (interposing). You say if the Commission feels that there should be any question about the discretionary power given therein, you would just as soon leave that out, so that it will just require an approval by the vote of the common stock?

Mr. SCHENKER. That is right, and I am no gambling man, Senator, but I will bet——

Senator MILLER (interposing). I would not want that change at all in the last sentence in section (b).

Senator WAGNER. What is that, Senator?

Senator MILLER. I say, I would not see any reason for striking out that last sentence in subsection (b) of section 13. I think it is the meat of that whole section, because it is very easy for a company to high pressure stockholders into a fundamental change. We have just got to do it. That ties it up with the representations made by the salesmen of their secuties when they organized the company and said, "We organized it for this purpose and we organized it for that purpose. That is a very good safeguard.

Mr. SCHENKER. We felt so, Senator.

Senator MILLER. I do not see how any legitimate industry would kick on that.

Mr. SCHENKER. Section 14 deals with sizes of investment companies, which is not an easy problem. You may ask, "Well, where did you get the figure that a diversified investment company should not have assets of more than $150,000,000 at the time it wants to sell securities?"

Senator WAGNER. We will recess now until 2:30 this afternoon.

(Thereupon at 12:10 p. m. a recess was taken until 2:30 p. m. of the same day.)

AFTERNOON SESSION

The committee reconvened at 2:30 p. m., upon the expiration of the recess.

Senator WAGNER (chairman of the subcommittee). Mr. Schenker, will you continue, please?

STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, SECURITIES AND EXCHANGE COMMISSION INVESTMENT TRUST STUDY, WASHINGTON, D. C.—Resumed

Mr. SCHENKER. We were discussing section 14 which relates to size of investment companies; the section provides that the diversified investment company or the fixed trust should not exceed $150,000,000 of total assets; the securities trading or securities finance company, $75,000,000; and those face-amount certificate companies, which sell securities which are really unsecured promissory notes, $200,000,000.

The question might be asked, Why did we impose or recommend the imposition of any size limitation on these companies? We are

not unmindful of the fact that it presents some problems. I think you must recognize that investment companies are a different type of institution than any other type of financial institution in existence today. You may say to me, "Mr. Schenker, they do not impose any size on insurance companies and they do not impose any size on savings banks. Your whole legislation is predicated at least in part on the fact that there is a kinship on the part of those institutions. Why do you impose a limitation on an investment company and why, if you do, don't you do it in connection with a bank?"

In connection with a bank the type of supervision they get is not even remotely comparable to the supervision they get here. In a bank the bank examiners examine every investment; they have a right to tell the bank's officers to mark the investments down to get rid of bad loans, and so forth. There is nothing that even approximates that in this bill.

Senator WAGNER. And they are limited in the character of the loans in which they can invest their money, too?

Mr. SCHENKER. They are limited in the character of the investments they can make.

Senator WAGNER. That is what I mean, too.

Mr. SCHENKER. The fact is, Senator, that you know the average large-size investment company constitutes today a bigger common-stock pool than any bank or insurance company in this country. You take an investment company that has $150,000,000 which it can invest in any and all common stocks: That is more than all the common-stock portfolios of all the life insurance companies in this country.

I have some figures on that which I whould like to give you: At the end of 1939 the common-stock holdings of one of the largest investment trusts in this country amounted to nearly $120,000,000; and the common stock holdings of four other investment companies amounted to $50,000,000 each. In comparison with that, the common-stock holdings of the largest life insurance companies were entirely negligible. The Metropolitan Life Insurance Co., for instance, reported only $25,000 in common stocks at the end of 1938; the Prudential Life Insurance Co. had $234,000 in common stocks; and the Equitable Life Insurance Co., $18,000 in common stocks.

As a matter of fact, the 49 largest life insurance companies together, according to the Association of Insurance Presidents, held only about $115,000,000 of common stock. So that you have a situation where the investment company is a bigger common stock pool than all the 49 largest life insurance companies in this country.

Now take that in conjunction with the fact that there is no limitation with respect to the extent to which they can turn over their portfolio and with respect to what common stocks they can go into. We shall develop in a moment, what the effect of no limitation upon size can be.

Now let me go on: The smallness of the holdings of these life insurance companies, of course, is attributable to the fact that they have got to invest in legals; and that is true of banks.

Let us take the fire insurance companies which do invest in common stock. None of the fire insurance or casualty insurance companies which are permitted to own common stock, and which do considerable amounts of common stock purchasing, had a portfolio valued at anything like $100,000,000. The Home Insurance Co. had a portfolio

of common stock at the end of 1938 of nearly \$60,000,000—probably the largest of any fire insurance company; yet we say an investment company can have up to \$150,000,000. The Hartford group, with total assets of \$172,000,000, held only \$17,000,000 of common stocks; the Great American group, with assets of \$71,000,000, had only \$19,000,000 in common stocks; the Aetna group, with \$67,000,000 of assets, had only \$7,000,000 in common stocks.

Senator TOWNSEND. Is the question of supervision the dominating influence over the thought of fixing the size of the investment trusts?

Mr. SCHENKER. No, Senator. The only reason I brought up the point of supervision is that I do not think you can analogize to a savings bank or a commercial bank, because the investments are closely supervised. More fundamentally, the nature of the investments of the savings banks is so different from the nature of the investments of investment companies.

I am not being disparaging when I say this, Senator; but in essence an investment company is a blind pool; you turn over \$150,000,000 to them, and they can invest in any common stock and they can invest in small blocks, large blocks, highly liquid securities in which they can get in and out fast, and so forth. I shall discuss in a moment the possible effect of a large common stock pool which is managed by one interest and what may be some of the consequences on the stock market and what may be some of the consequences on the investor.

Senator, we have no interest in size per se. But in the open-end company, the stockholder has the right at any time to tender his stock and get his asset value: If you were to have a run on that type of company—and it is no different from a run on a bank, Senator—you can see that if you had \$150,000,000 invested in large blocks of stocks, if the time comes when for some reason or other the stockholders in the company are dissatisfied with the management and they decide to tender their stocks for redemption, you will get a program of liquidation which may result in two things: In the first place, an undesirable effect upon the stock market in general. In the second place the stockholder who tenders his stock for redemption a little later may find himself with an illiquid stock and who may not be able to get his asset value.

Senator TOWNSEND. Have you any standards set up in this bill with respect to the kind of stocks in which they can invest?

Mr. SCHENKER. I beg your pardon, Senator?

Senator TOWNSEND. Do you have any standards set up in this bill with respect to the kinds of stocks in which they can invest?

Mr. SCHENKER. No.

Senator TOWNSEND. Do you think that would be practicable?

Mr. SCHENKER. That in my opinion, Senator, would be an attempt to influence or dominate management. This bill has taken meticulous care, in my opinion, not to tell these fellows how to run their business. After all, the persons who are buying it are buying it on the reliance that Mr. A, who is supposed to be an expert, is running it. This bill gives him absolute and unlimited discretion and power to invest in any stock, in any industry, and in any situation he wants. However, we say there comes a time, when you reach \$150,000,000, particularly in the open-end companies, where there may be undesirable consequences to the investor and to the public interest.

Senator TOWNSEND. Will you give an illustration of why you think $150,000,000 might be more dangerous than $300,000,000 or less dangerous than $300,000,000?

Mr. SCHENKER. Well, Senator, the answer to that is that there comes a point where you must draw an arbitrary line. Why did we take $150,000,000? Because the people whom we examined almost unanimously agreed that $100,000,000 is enough. The things that persuaded us to recommend to the committee that $150,000,000 be taken as the top figure are several: In the first place, all the witnesses whom we questioned said that $100,000,000 is enough for anybody to manage. With respect to one company in particular, which is run in a high-class manner and by one of the finest and most reputable persons in this industry, we were told by its manager, "When we reach $50,000.000, I have got enough to manage." There was almost a unanimous consensus of opinion that $100,000,000 ought to be enough.

In the second place, when we look at the records in this country of the investment companies, we find that the companies that had over $100,000,000 were the ones that took the worst lickings. For instance, the Pacific Eastern Corporation, which is the new name for Goldman Sachs Trading Corporation, had $326,000,000 contributed. When the company was turned over to the Atlas Corporation they had about $40,000,000. The United Founders group, the one Mr. Carl Stern described, had $500,000,000, and they wound up with $40,000,000. The Blue Ridge Corporation received contributions from the public of $137,000,000. They had at the end of 1939, $36,000,000. The Shenandoah Corporation had a total invested amount of $169,000,000, and they finished up with $28,000,000.

Then you have the Central States Electric Corporation, which we described somewhat this morning. It raised $134,000,000. Today it has $15,000,000. The Insull Utilities Investment Co. started with $250,000,000 and then wound up with $33,000,000. Continental Shares, Inc., of Ohio had $111,000,000, and when they went into receivership they had $3,000,000.

You may say, Senator, that that is a matter of coincidence; but the fact of the matter is, as we learn from our study of every investment trust in this country, that there seems to be some correlation between the amount of losses that were sustained and the size.

The fact is also, Senator, that even in the British investment trusts the average size is from $20,000.000 to $30,000,000. Some of them are in groups. But even when you consider the groups, we do not know of a case of an investment trust group in Great Britain which has exceeded $100,000,000.

It is very difficult to put your finger on the precise reasons why we take $150,000,000 as the limit, and not $200,000,000. Our selection of that figure of $150,0000,00 as the maximum was based on the record, it was based on their past experience, it was based on what we have been told, it was based on the nature of the companies, it was based on the potentialities, and upon our conclusion that in this type of company there ought to be a maximum size. Although we felt in the first instance that we ought to recommend $100,000,000, we increased it to $150,000,000 in order to cover all existing situations.

You also must be conscious of the fact that we do not say that if an investment trust reaches the size of $150,000,000 it has to cut itself down. If a fellow starts with $100,000,000 and runs it up to $3,000,-

000,000, this bill does not say that when he reaches $150,000,000 he cannot make any more money for his stockholders and has to quit.

The only thing we say in this bill is that if you have total assets of $150,000,000, then you cannot go out and sell new securities to raise new capital. In other words, when you have reached that point, then we say you have enough capital to work on; but if you can run $150,-000,000 up to $3,000,000,000, this bill does not stop you. We simply say that if you have $150,000,000 of assets, then you cannot start selling new securities, to get new money as capital.

We made some exceptions for the so-called open-end companies. We said, "Well, you can sell an amount equal to the amount of securities which people redeem. In my opinion that will not compel them to cut down the size. The fact of the matter is that at the present time the largest open-end company has assets of $120,000,000. They still have a ceiling of $30,000,000 additional. We say that in our opinion the protection of the investor, particularly in the open-end company, requires some limitation on size. We think $150,000,000 is a reasonable figure at which to cut off that limit. That is this whole size section.

You will notice that we differentiated between diversified investment companies and securities trading corporations. The reason that impelled us to do that is that it was practically conceded that a distinction should be made between those two types of companies. The securities trading company or securities finance company gets into control situations, and with $75,000,000, if you want to go out and buy control of corporations in this country, you can get control of a tremendous number of corporations.

The fact of the matter is that the Phoenix Securities Corporation, with total assets, the last time I looked at it—and perhaps a little more today, because of their Pepsi-Cola holdings—of about $16,000,000, were able to exercise a great deal of control. With that $16,000,000, Senator, as I said before, they controlled the United Cigar Stores, they controlled Loft, Inc., which in turn controls Pepsi-Cola; they controlled Celotex, and through Celotex they have a controlling influence in Certain-teed Products. They control the Southwest Corporation and have a controlling interest in Autocar. At one time they had a controlling interest in the Lincoln Hotel. You have such situations where you can get a tremendous concentration of wealth in an investment company.

It is quite true that when you get into controlling investment corporations, the amount of their assets should be less. Thus you see Goldman Sachs Trading Corporation with its $360,000,000 of assets controlled, and by "controlled", I mean 50 percent or almost anywhere over 20 percent—about $1,600,000,000 of assets owned by banks, insurance companies, and industries in this country. That is the reason why we fix that limitation.

We fix $200,000,000 for the so-called face-amount certificate companies because this bill requires, for the protection of investors, that their assets should be comparable to those of a life insurance company. Under those circumstances we feel that since they do not invest in common stocks with all this trading and fluctuation in values, $200,000,000 may be sufficient. Perhaps it ought to be a little higher; I do not know.

However, there is no magic about this; there is no ulterior motive about this. We have come to the definite conclusion that an individual who manages $150,000,000 has a man-sized job on his hands, to look after that amount of money. That is particularly true in view of the fact that this bill lets him manage one company and act as investment adviser to others. In the aggregate, he can manage $150,000,000.

Senator WAGNER. Mr. Schenker, may I ask you a question right at that point?

Mr. SCHENKER. Yes, Senator.

Senator WAGNER. When do you ascertain the value of the assets—that is, to determine whether the total assets are above or below $150,000,000?

Mr. SCHENKER. If he wants to issue securities, Senator, he must come to us and file a registration statement. At that time we ask him, "What are your total assets?"

If he says they are $150,000,000, that is ground for denying his registration and application for a new issue of securities. So, Senator, at the time when he makes that application, if he wants to issue new stock to raise money for his company, that is the time when we look at the assets of the company.

Senator WAGNER. So it is the assets as of that day?

Mr. SCHENKER. That is right. Senator, if there are any further questions, I should be glad to answer them as best I can.

Senator WAGNER. Of course, the fixing of that particular limitation is to a considerable extent a matter of judgment, is it not? It is one of those flexible matters? Of course, you have given a basis for the conclusions which you have reached.

Mr. SCHENKER. Yes, Senator; you could have set it at $125,000,000 or $175,000,000.

Senator WAGNER. Yes.

Mr. SCHENKER. When we get around $150,000,000, for this type of institution, then we feel that it requires the entire time of the individual.

Judge Healy calls my attention to the fact—and I thought that was inherent in my statement—about an open-end company that had $120,000,000 of assets. As I remember, there is not a company in existence today which is touched by this provision. Every single one of them could issue more securities to raise more money.

Senator WAGNER. Yes.

Mr. SCHENKER. The one that is nearest to it has about $120,000,000 or $130,000,000, so it still has $20,000,000 to go.

The next subject which is covered by the bill is section 15, which relates to management contracts. May I make this observation: When we concluded that we ought to recommend $150,000,000 as the maximum, we were not unmindful of the fact that the bigger the size of the trust gets, the possibility exists that they may cut down a little in their operating expenses. However, I think that cut-down in their operating expenses does not compensate in any way whatever the disadvantage to the investor, when the size of the fund is over $150,000,000. In the case of the open-end company it does not compensate for the possibilities of risk if there should be a run on that particular company.

You talk about diversification of risk by investing in an investment company: What greater safety do you have with respect to diversifica-

tion of risks and in connection with runs upon these companies, by keeping them to a fairly reasonable size? Suppose you had a company with $300,000,000 or $400,000,000, and suppose for some reason or other, whether justified or not, that company's management was suspect. If you got a run on that $300,000,000 corporation, you can see the havoc that could result. If that three or four hunderd million dollars were spread over five or six companies, you might not get the same situation.

In a savings bank they attempt to get some protection against runs, because they limit the amount that a single depositor can have. This is an added reason, we think, why there ought to be some limitation on size.

If I may take a moment to discuss these management contracts, Senator, I should like to say—I may be wrong about this—but I believe that investment companies are the only type of companies where you have this institution of management contracts. That, to our mind, presents an anomalous situation.

Judge Healy called my attention to the fact that you may have an analogous situation in public utility holding company systems, where you have service companies which may have the management contracts and operating contracts. However, aside from that possibility, I do not know of any other industry, financial institution, or any organization that has this system of management contracts. As I said before, in some respects to my mind, at least, it presents an anomalous situation. Here you invest your money in a corporation. Ordinarily in a corporation the managerial functions are performed by the officers and directors. After all, that is what the corporation is. The corporation is really the officers and directors.

However, when we come to investment companies, we find the situation existing where the officers and directors, if they have not done it in toto, have delegated a substantial part of their managerial functions. You find a situation where the persons who are supposed to be vested by the stockholders with the managerial discretion or function have delegated that managerial function to someone else.

That may be almost a complete delegation of function. The only thing that makes it incomplete is that the board of directors may at some subsequent time ratify the action of the managers; or it may be a partial ratification of the delegation of function. In any event, you have the situation where the very purpose for which the company was formed and the very powers which were supposed to be vested in the officers and directors are delegated to other individuals, who may or may not be the same individuals as the officers and directors.

During the course of our investigation there were quite a few people who said, "David, you will just make yourself a laughingstock down on the Street if you permit management contracts." They said, "Who ever heard of a management contract in a bank? Who ever heard of a management contract in an insurance company? Who ever heard of a management contract in any industrial corporation?"

Senators, you must realize that the management contract I am talking about is not the same thing as a bonus arrangement made with an officer who does a particular job. These are formal contracts by which these individuals are given the power to give investment advice and in many instances manage the portfolio. Sometimes that contract runs for 10 years. And, curiously enough, although I know

of no other trustee relationship where the trustee can do that, he has the power to transfer that management contract to someone else.

People down in the Street have told me—people who control investment trusts—"Why should this be any different from any other financial institution? They ought to have paid officers and paid directors." If they want to pay themselves a million dollars, why, that is all right; we do not fix the amount.

Well, that presented, theoretically at least, a potent argument. However, we made a detailed study of the industry. We found that although when you get into the large companies, they could afford to pay salaries of such size as to attract competent people and people with ability, on the other hand, when you get down to the smaller companies, in their cases if you started paying salaries, those salaries would eat up all the ordinary income and all the profits.

So you had this situation: Should you abolish management contracts and say "Paid officers and directors"? Should you try to differentiate between large-sized companies and small-sized companies?

Well, the Commission felt that under the circumstances if there were a few elementary safeguards set up with respect to management contracts, they could see no difficulty with that situation.

I know that this is not in accord with the views of many people in the Street, and the fact is that there are many investment trusts that have paid officers and directors, just like any bank or insurance company. However, we said, "If the industry feels that the practice is indigenous to that type of institution, we may have some difficulty with it, but we would not recommend to this committee that the status be disturbed."

What have we done with respect to management contracts? There is not a single provision in section 15 which even remotely assumes to fix what they should be paid as compensation.

As a matter of fact, in Senator Taft's State the "blue sky" laws were recently amended, and they have a provision that investment company securities could not be sold in that State if the management and operating expenses exceeded 1½ percent of the average total assets.

We do not have that. We feel that is a question for the stockholders to decide. If they want to pay a man a million dollars to manage the fund and if they know they are paying him a million dollars and if they have the right to approve the payment of a million dollars, this bill says that is perfectly all right.

Section 15 (a) virtually says that you cannot act as a manager unless you are paid in one of three methods. One of those is where you get a definite sum per month or per year; that would be a salary basis. Another is a percentage of the income. The third method is a definite percentage of total assets—or any combination of these three.

What we aim at really is to kill profit-sharing arrangements, where a man makes an arrangement to the effect that he will take a cut of the profits but he does not take any cut of the losses. It is one of these "heads I win and tails you lose" propositions. By and large, I do not think the industry finds any difficulty with this provision.

Subsection (b) provides in substance that the contract has to be in writing. We felt that that was necessary because we saw some arrangements, and we have studied hundreds of management contracts where sometimes the contract was oral and sometimes it was

just a slight reference in the minutes. Sometimes it was an elaborate contract.

We say that it ought to be a formal agreement between the corporation and the managers, setting forth—what? The compensation to be paid. We say that in the first instance it cannot last more than 2 years and that the board of directors shall have the right to terminate it on not more than 60 days' written notice. The fourth provision is that you cannot assign the contract.

Let me discuss that last provision at this point, because I think that presents the simplest situation. Here you have a situation where a person assumes a fiduciary obligation; he is the manager of other people's money. If he is through with the job, he ought to go home. However, instead of that they take these 10-year contracts which they have the right to assign to someone else.

This provision says that the management contract is personal, that it cannot be assigned, and that you cannot turn over the management of other people's money to someone else.

The third part is a provision for termination on not more than 60 days' written notice. We have made an analysis of a great many management contracts, and many of them contain the provision that the manager can terminate on 60 days' notice. The company should also have the right to terminate on 60 days' notice. We feel that the relationship is really a personal one and that if the stockholders or the board of directors are displeased with the management, they ought to have a right to terminate the contract.

The other provision, with respect to the 2 years, is to take care of situations where a 10-year management contract or a 5-year management contract is voted the managers and there comes a time—and I shall illustrate that in a moment, with an example—where the stockholders are dissatisfied with the management, and the only way they can get rid of the management is to pay these people a substantial sum of money, in order to get a termination of the contract.

So we say the management contract can be for 2 years, if it is approved. Thereafter it is renewable yearly. We say that annually it has to be approved by the directors or the stockholders. If it is for 2 years, it has to be approved by the stockholders. Thereafter it can be year after year approved either by the directors or the stockholders.

Now coming to subsection (c), that is an analogous provision for the person who has the distribution contract with an open-end investment trust. I think the difference in this situation is that we say it does not have to be approved by the stockholders, because in that instance the stockholder, after he buys the security, has no more interest in the distributor. The manager manages his funds. Once he has purchased the security, he should have no control over who the distributor should be. It is the function of the directors to select the person to distribute the securities and to determine what his compensation should be.

In subsection (d) it is simply stated in substance that the management contract, if approved by the board of directors, should be approved by independent members of the board of directors, and that

the person who has an interest in the contract should not be counted in a quorum, and that his votes do not count.

Subsection (e) applies to this situation: You have these investment company systems like United States Electric Corporation—and we have others. In that situation we have made provision for mutualizing the management. In some situations what happens? The sponsors of the top holding company have the common stock of the top holding company. The top holding company acts as investment counsel for the lower companies, so that the top holding company is making money on the lower companies because of the management fees it is charging the lower companies. The "insiders" or the sponsors having the stock in the top company benefit in that way from the management fees charged the lower companies.

In that circumstance we say that provision ought to be made for a mutual management company which will manage all the companies in the system and allocate the cost equally throughout the companies, based upon the amount of assets of each company. The fact of the matter is the Tri-Continental Corporation, as I understand it, only recently formed a mutual investment company to service all the companies in its system.

Section 16 deals with changes in the board of directors, and is precisely the provision contained in the banking law of the State of New York which says that you cannot elect more than one-third of the board of directors in-between meetings of the stockholders.

The fact is that in every case that we saw where there was a transfer of the control of an investment trust, the procedure that was used was—what? Let me say, here, this is one of the reasons why the stockholders were kept in ignorance of changes or transfers of control. In the Continental Securities case they could not have accomplished their purpose if it had not been for the fact that at the time when they bought the controlling block of stock, one of the members of the incumbent board of directors resigned, and a new man was elected. Then another one resigned, and another new one was elected; and then another one resigned, and a third one was elected. So, through this form of seriatim resignations and elections, the whole board of directors was changed in 5 minutes.

We say—and that is precisely what the New York banking law says—that if the board of directors which was elected by the stockholders is going to change substantially in complexion, then the stockholders ought to have something to say about who shall be the new directors. However, we can visualize situations, because of emergencies, death, sickness, resignation, where you ought to be able to change up to one-third of the directors without the vote of the stockholders. That is section 16.

Senator Taft. Mr. Schenker, I do not want to interrupt; but because of the fact that I was in the Senate at 2:30, perhaps I have missed something of your explanation.

What is the reason for limiting the size of an investment company as you propose to do in section 14? What are the present sizes? Does that affect any existing companies?

Mr. Schenker. No, Senator; the nearest one to that is an open-end company which itself has $120,000,000, and another company which is under the same management, which has $10,000,000—which in the aggregate makes about $130,000,000.

Senator, may I make this observation: When you say this limits the size, that may not be a precise description of the effect of this section. What we say, Senator, is that if you have $150,000,000 of assets, there is nothing in the world to prevent you, through your expert management, from going to $2,000,000,000. We say that at the time when you have $150,000,000 of assets, you cannot raise new capital through the issuance of new securities.

So if you started with $10,000,000 and went to $3,000,000,000 through appreciation in assets, this section does not even remotely touch you.

Senator TAFT. I mean why do you hit on $150,000,000 or $200,000,000? Is it just the idea that they ought not be too big; is that the idea?

Mr. SCHENKER. It is the idea that they ought not be too big—the idea that $150,000,000 in an investment company is a bigger common-stock pool than the 49 largest insurance companies of this country have in the aggregate.

Senator TAFT. In common stock?

Mr. SCHENKER. In common stocks.

May I just read this one thing, Senator?

Senator TAFT. If you have already done so, do not do it again, of course.

Mr. SCHENKER. Yes; but I have not done this, and I think you will be interested.

Senator TAFT. Yes.

Mr. SCHENKER. When we come to the companies which are open-end companies, where the stockholder has a right to tender his stock for redemption, where you can get situations which correspond to runs on banks, and where these types of companies have to invest in concentrated blocks of common stock, you have two situations: You may very substantially affect the securities markets in those situations, you may also create a situation where the fellow who gets in first may get his money, whereas the fellow who comes in later may not.

You take the very company that I am talking about, which has assets of $120,000,000: Mr. O. O. Sprague, who was financial adviser to various administrations of the Government, is on the board of advisers of that company. We asked his opinion on size. Practically the unanimity of opinion is that when you get up to $100,000,000 you have a man-size job because you have practically a blind account. There is no limitation on how fast they can turn over their portfolio or how concentrated their blocks can be, and so forth, except for the limitations specified for a diversified company.

What did Mr. Sprague say?

Has any size been discussed, Mr. Sprague, any limitation of size?

Not very definitely. I think there was a vague feeling at one time, long before we had reached a hundred millions, that perhaps a hundred million dollars was about as high as any trust might well go.

And is that your personal feeling?

Oh, I would not like to fix it upon any particular figure, and if it were a very slow accretion I do not know but that I should be prepared to contemplate going to $150,000,000.

Whereas if we were to secure 50 millions in the next 15 months, I should greatly regret it.

And you would feel that that was perhaps a little too big to be readily handle-able?

Yes; if you have a large amount of new money coming in each week, I think it is rather probable that it does affect your handling of your existing portfolio a little. You won't quite so readily, perhaps, sell something if you have got a half million or so of new money already there to invest, that week.

The fact of the matter is that in Great Britain the average investment in an investment trust is $30,000,000.

In the situation in England, where they have common management for a group of investment companies, we do not know of any instance where the group's assets exceeded $100,000,000. Of course there is an arbitrary element in that. Maybe that should be $175,000,000; maybe it should be $125,000,000. We took $150,000,000 because we did not want to touch any present situation.

The fact of the matter is that this company has a ceiling of $30,000,000, and if the company can grow to $30,000,000 through their management, more power to it.

Section 17 has to do with transactions of certain affiliated persons and underwriters.

I was interested in your observation, Senator, about affiliated persons. I was afraid that some time you would take a look at this and become a little frightened. Maybe if I explained it it will not seem so awesome.

The only thing this section says is that a person who is an officer, a director, a manager, or underwriter, shall not as principal sell any property to the investment trust. And that is obvious, because where he is attempting to sit on both sides of a transaction, where he has a personal pecuniary interest as a seller and is acting in a fiduciary capacity with respect to the investment trust——

Senator WAGNER. You have had some instances of that, have you not?

Mr. SCHENKER. Yes. I am not saying that it is going on to the same extent now as it did in the past, but it still happens; and I do not think the industry takes any umbrage at this particular provision.

In the case of Iroquois Share Corporation the brokerage firm which managed the investment trust, at the bottom of the real estate market, sold a building up in Buffalo to the investment trust for $313,000, which was exactly what it cost. The investment company bailed them out of the real estate.

Senator WAGNER. It was a bailing out, was it?

Mr. SCHENKER. Yes.

There was another situation in Buffalo. Niagara Share Corporation was sold a distributing agency in 1932 by its managers who bought the distributing business back later. That may have been fair; we do not know. But we say under the circumstances that we do not think an officer or director ought to be willing to put himself in the position where he is sitting on both sides of the table. He cannot knowingly sell property to the trust. He cannot knowingly purchase property from the trust; he cannot borrow any money from the trust. If I had the time, if the Senate committee is interested, to give you the figures of the aggregate amount of loans made to officers and directors of investment companies, it would be of interest.

The fourth one is that if affiliated persons go into a joint enterprise with an investment trust they cannot do it in contravention of such rules and regulations as the Commission shall formulate to insure fair dealing and no overreaching.

Possibly the only elaboration that this requires at the present time is an explanation of what is an affiliated person.

You see how easy a provision like this would be of circumvention if we said that an officer cannot sell. Then suppose his partner sells, or his partnership sells, or he organizes a personal holding company, which makes the sale.

So an affiliated person is nothing but an officer or director or any partner of his in a firm in which he is a partner. Also no corporation which he controls can sell any securities or property directly to the investment trust.

In order to make sure that there is no injustice done, you will notice that the statute says specifically "shall knowingly sell." That is to take care of cases of good faith and inadvertence.

Subsection (b) presents this situation. I think I can best illustrate it with a case. Take the Atlas Corporation. It has a controlling interest in Bonwit Teller, a department store in New York. It has also a controlling interest in Franklin Simon, another department store in New York. What we say is this: If the Atlas Corporation wants to sell Bonwit Teller to John Wanamaker, it should be no business of the Securities and Exchange Commission. You have two people there who can take care of themselves—John Wanamaker and Floyd Odlum. However, if the Atlas Corporation wants to sell Bonwit Teller to Franklin Simon—where the Atlas Corporation has a controlling interest in both companies, but there is a separate and distinct public interest in each one of the corporations—then in that event you have not got an arm's length dealing. In those circumstances the transaction should be subject to the scrutiny of some independent agency as to its fairness.

Mr. Floyd Odlum has testified and has said that so far as he is concerned—and he said it repeatedly during the course of the investigation, and I think he would be prepared to say it if he were called—that he would welcome the institution of an agency to which he could come down and say, "I am in this conflicting position. I control both these situations, but there is a big public minority interest in one and there is a big public minority interest in the other. You take a look at it and tell me if it is fair, if it is all right."

Senator Taft. You have an investment trust getting a minority interest in two other concerns?

Mr. Schenker. It takes a majority interest in two.

Senator Taft. Control in two different companies?

Mr. Schenker. Yes.

Senator Taft. And the question is whether they shall sell one company to another company in which they have an interest?

Mr. Schenker. That is right. This relates not to the sale of merchandise. If Bonwit Teller wants to sell some dresses, that is all right. But if the Atlas Corporation wants to take its holdings in the Bonwit Teller Co. and sell them to the Franklin Simon Co., so that Franklin Simon would control Bonwit Teller, since the Atlas Corporation controls Bonwit Teller and controls Franklin Simon, it is sitting on both sides of the table.

Senator Taft. And the purpose of the Securities and Exchange Commission is to fix the price.

Mr. Schenker. No; that is not it.

Senator Taft. Who is to fix the price?

Mr. Schenker. We have tried to set forth, Senator—and, again, I am not unmindful that it is a difficult problem—the precise things which should be considered in such a situation.

Senator TAFT. Supposing an individual owns a majority interest in both companies: Why should we legislate about it, when you have a long series of common law decisions as to what a majority stockholder can do and cannot do? What difference does it make whether it is an investment trust or a rich man? I mean, what has it got to do with the stockholders of an investment trust?

Mr. SCHENKER. In the first place, the rich man has his own money through which he can control one company and the other. In the investment company situation the fellow who controls the investment company may have no interest in the company, exercises control not through his own money, but through the public's money.

With reference to the hypothetical situation which you gave me, I am not sure whether you include as a fact that the rich individual had—well, here [indicating on sketch] is the rich individual. Does he own a controlling interest in "A"?

Senator TAFT. He owns a controlling interest in "A" and also in "B," and he wants to sell "A's" assets to "B." There is a long series of common-law rules as to whether he can or not. He has to be pretty careful, undoubtedly. If the minority votes against him he is certainly taking a chance on the thing. Which one are you trying to protect? Are you trying to protect the stockholders in the investment trust?

Mr. SCHENKER. There are two aspects. Senator, There is the protection of the minority stockholders, and then there is the protection of the investment company, because the particular transaction may redound to the benefit of one class of security holder and not to the other. But if the controlling person who controls the investment company, who does not control it by virtue of his own money invested in it—that is, he does not control both the department stores through his own money but through the investment company's money—then we say that under those circumstances the whole thing ought to be subject to scrutiny.

Senator TAFT. I do not quite see, though, just where the conflict of interest lies.

Mr. SCHENKER. The conflict is between those minority stockholders of the two department stores.

Senator TAFT. You are branching out a long way when you are trying to regulate investment trusts, trying to protect minority holders in investment companies.

Mr. SCHENKER. This may be a closer case and may be more analogous to your situation, Senator. Take the situation where you have intercompany transactions, where one investment trust may sell securities to another in the same system. In those circumstances you have the problem whether or not that particular sale redounds to the benefit of the controlling person who may be a common-stock holder. You have that complex situation where you have intercompany transactions, where those intercompany transactions are really involving public funds but are in the control of an individual who may have an interest in the whole picture only through ownership of common stock. That transaction may not be for the benefit of the debenture holders or the senior security holders. There is a variety of intercompany transactions.

Let me give you another example, Senator. There may be a great deal in what you say. Here is an actual case. The Phoenix Securities Corporation owned a 20-percent interest in Celotex Corporation. It

also owned approximately a 20-percent interest in Certain-teed Products Corporation. About a year or 18 months ago the Phoenix Securities Corporation had the Celotex Corporation buy Phoenix's holdings in Certain-teed at one-half million dollars premium above market.

They were on the three sides of the transaction. It is true, Senator, that after we held a public examination upon it, a stockholders' action was instituted.

Senator TAFT. I would think so. Any lawyer in Cincinnati would institute it in a hurry. The only question, to me, is the publicity.

Mr. SCHENKER. The publicity, Senator; and there is no greater believer in the prophylactic effect of sunlight than I am; but the unfortunate thing is that unless there is an agency that goes in with a flashlight, the stockholder never gets the publicity.

That was true in this transaction. We saw that there was some contemplated transaction in which these people were going to sell their Certain-teed stock to Celotex at a half million dollars premium above market. Certain-teed was not doing so well. I am not saying it was not a good deal. It may have been. They were not unrelated industries.

Senator TAFT. They may have had some interlocking directors that I do not know about. But the same abuse could be conducted by an individual. Again, this is a case where you meet the problem of corporation laws which are inadequate in many cases to protect minority stockholders. But we cannot protect them very far by regulating investment trusts. We just scratch the surface.

Mr. SCHENKER. The only distinction between your hypothetical case and mine, Senator Taft, is that one is an individual and the other is a holder of public funds.

Mr. HEALY. Would not section 17 (a) (1) operate, for example, to forbid Mr. Floyd Odlum from selling property to the Atlas Corporation? Would it, Mr. Schenker?

Mr. SCHENKER. That is right.

Senator TAFT. Who is he?

Mr. SCHENKER. He is the president of the Atlas Corporation.

Mr. HEALY. There is a prohibition against his selling property to the Atlas Corporation in section 17 (a) (1). That is an out and out prohibition. Then the effort was made—I do not know whether wisely or not—to permit it after it passed the scrutiny of an agency such as the S. E. C. But here is the "rubber" in the statute, either in subsection (b)—I was not strictly accurate. (b) applies to intercompany transactions, and not to the case of individuals. But, at any rate, it represents, as I understand it, a means of establishing an exception to the prohibitions that are established in the earlier parts of the section.

Senator TAFT. Passing over the examples given, they do not seem to be quite the same as this. You mean that the object of this section is to prohibit a man from selling his own securities or the securities of a company which he controls, to the investment trust itself?

Mr. SCHENKER. Yes.

Senator TAFT. That is the main purpose?

Mr. HEALY. That is one purpose.

Senator TAFT. That is the underlying purpose. But you say that he may come to the S. E. C. and have that Commission conduct an

examination, and they may approve of his selling to the Atlas Corporation. Is that the effect of (b)?

Mr. SCHENKER. No, Senator. We feel it is analogous to the situation where an individual who is in control or managing or is an officer of the corporation tries to sell his property as principal to investment trust. Then we say that if one investment trust dominates the other investment trust, he should not be able to sell securities to the dominated investment trust without any scrutiny.

Let me give you an example, Senator.

Senator TAFT. Maybe they should not be allowed to sell it at all.

Mr. SCHENKER. The fact of the matter is that there is some sentiment in the industry to show——

Senator TAFT (interposing). I do not see why they could not go to the stock exchange to buy them.

Mr. SCHENKER. The fact of the matter is that I discussed this with Mr. Hoxsey of the Stock Exchange, and he is outraged when he sees one investment trust controlling another and selling securities to that investment trust.

The first type of example I gave was a variant of it; but if you take a situation which is analogous to an individual selling to an investment trust, you have one investment company controlling another and selling securities to the controlled investment company. Maybe it ought to be prohibited entirely.

Senator WAGNER. That is not the instance of the two department stores. They were owned by one investment trust.

Mr. SCHENKER. That is another situation.

Senator WAGNER. I have been trying to pursue that.

Mr. SCHENKER. In 1929 the Eastern Utilities Investing Corporation issued $38,000,000 of debentures to the public. There was a $6,000,000 banking commission, and the bankers wrote out a check for $32,000,000 and turned it over to the Eastern Utilities Investing Corporation controlled by a Hopson group of directors. The Associated Gas and Electric Co. controlled the Eastern Utilities Investing Corporation. So you had Hopson on the board of directors of the Eastern Utilities Investing Corporation and Hopson on the board of directors of the Associated Gas which controlled the Eastern Utilities Investing Corporation. Although the prospectus said, "We are going to use this money to buy $32,000,000 of diversified securities," they did not even bother to deposit the check, but endorsed it right over to the Associated Gas. Instead of buying Consolidated Gas and various other utilities, Associated Gas sold to Eastern Utilities Investing Corporation $32,000,000 of Associated Gas stock.

That is analogous to a situation where an individual controls an investment company and sells stock to the investment company. Is not that analogous to a situation where one investment company controls another and sells it securities?

Maybe that sort of a situation ought to be prohibited, just like the individual is prohibited. We feel that there may be circumstances in intercompany situations where it might be unobjectionable. That is one of these "rubber" sections that I think the industry does not object to, Senator.

Senator TAFT. An affiliated person includes any person owning 5 percent or more of the outstanding voting securities. That makes the definition of an affiliated person, does it?

Mr. SCHENKER. Paragraph (18) on page 90 provides (reading):

"Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, or co-partner of any such person.

That means an officer, director, any partner of his in a partnership, and any company of which he is a 5-percent owner.

Senator TAFT. Frankly, it would take all afternoon to study section 17 to find out what it means, before I begin to criticize it. You define what would be an affiliated person, or any affiliated person of such a person acting as principal; and then you say that no affiliated person of an affiliated person of a registered investment company shall sell any stock to the company. Is that the English of it? It is certainly pretty hard to understand what this section does prohibit and what it does not.

Mr. SCHENKER. What we tried to say—and it is a little complicated—is that no officer, director, or controlling person, no partner of his in a firm in which he is a partner, and no company which he controls, shall have the right to sell property to the investment trust.

Otherwise it would be very easy of circumvention. If he wants to sell some property to an investment trust he will not sell it personally; he will organize a personal holding company and put the property in the name of that company and have it sell the property.

The use of the term "affiliated person" is an attempt in a shorthand way to spell out those situations that I have enumerated. Maybe we have not said it, but I think we have.

Senator TAFT. If you have on the board a man who owns a 5-percent interest in another company, he is an affiliated person of that company?

Mr. SCHENKER. He would be an affiliated person of the investment trust, and the company would be an affiliated person of his.

Senator TAFT. That company in which he owned 5 or 6 percent of the common stock could not sell any securities to the investment trust?

Mr. SCHENKER. That is right.

Senator TAFT. Does it go beyond that? Does it go to an affiliated person of that company or some other person who owns 5 percent of that company's stock, and provide that he could not sell either? Is it to the second degree?

Mr. SCHENKER. He could sell it. We tried to get the situations where it would be to his pecuniary interest to unload securities on the investment trust. We figured that if he had a 5-percent interest in the company that is selling the securities, then he has a sufficient interest to affect his judgment, and therefore we say that he cannot sell.

Senator WAGNER. He is a director of the trust?

Mr. SCHENKER. Yes; by virtue of the fact that he is a director, he is an affiliated person of the trust; and by virtue of the fact that he owns 5 percent of the securities of the company that is going to sell property to the trust, that company is an affiliated person of his. That is why we say "an affiliated person of an affiliated person."

Senator WAGNER. You go one step farther, and provide that a copartner cannot sell either?

Mr. SCHENKER. That is right.

Senator WAGNER. You do go that one step farther?

Mr. SCHENKER. Yes, sir.

Section 17 (c) provides that a person may sell merchandise in the ordinary course of business to any affiliated company of a registered investment company if such affiliated company is not itself an investment company. That does not apply to ordinary merchandise sold in the ordinary course of business.

Subsection (d) of section 17 says, in substance, that an affiliated person or any affiliated person of an affiliated person can act as an agent and receive compensation in any transaction except in the brokerage case.

You might say, Why did the Commission write that? That is because we found cases where although the controlling person did not sell any property to the investment trust, he was a real estate agent in the transactions in which real estate was sold to the investment trust, and we feel under those circumstances that he has this conflict of interest. But he can act as the broker for the trust and he can act as the underwriter or the distributor of securities.

Subparagraph (2) says that if he is going to act as a broker he may get the ordinary stock exchange brokerage commission.

Mr. HEALY. I want to say one word there. I am not sure that that provision should not be restricted by having a corresponding provision for over-the-counter transactions where just the ordinary going commission is charged. It may be a little bit too tight.

Senator WAGNER. Will you prepare something for the committee on that?

Mr. HEALY. Yes, sir.

Mr. SCHENKER. Subsection (e) of section 17 attempts to set forth a broad standard of conduct.

You made a suggestion originally, Senator Taft, to this effect: Why can you not set forth in this bill a fiduciary obligation and make it a crime to violate that fiduciary obligation?

When we came to draft a provision like that it presented a great many problems, because if you try to impose a trustee obligation on these managers, maybe that obligation is much too strict. A trustee in some instances may be liable for negligence. We felt that that was possibly too onerous an obligation to impose upon people who are managing investment companies. So we took the broader approach and said that if he was guilty of gross misconduct or gross abuse of trust, then he was guilty of a crime.

Of course that does not mean that the Securities and Exchange Commission has the jurisdiction to determine whether he has been guilty of gross abuse or gross misconduct or gross abuse of trust. That is a criminal offense, and criminal action would have to be instituted against him.

Senator TAFT. There is a criminal statute which covers that, is there?

Mr. SCHENKER. Yes, sir; and penalties are provided for it. The penalties are referred to in section 43 on page 84 of the bill.

Senator TAFT. Section 43 provides that any person who willfully violates any provision of this title or of any rule, regulation, or order

hereunder shall upon conviction be fined not more than $10,000 or imprisoned not more than 2 years, or both.

That seems rather a stiff criminal provision.

Mr. SCHENKER. I do not think it is any different from the criminal provisions in other acts, and I think it must be read in the light of the fact that there is a special provision here which relates to violation of rules or regulations which says that the mere inadvertent violation of a rule or regulation is not sufficient to impose liability. If you read the balance of it you will find it says that no person shall be convicted under this section for the violation of any rule, regulation, or order if he proves that he had no knowledge of such rule, regulation, or order.

Senator TAFT. What kind of knowledge?

Mr. SCHENKER. Under those circumstances, Senator, I think he would have to prove beyond a reasonable doubt——

Senator HUGHES (interposing). Actual knowledge would have to be proved.

Mr. HEALY. This bill says willful violation. I do not believe constructive notice would be sufficient.

Senator TAFT. He is presumed to know the law, but the facts may be different.

Senator WAGNER. It cannot be willful if he knew nothing of the law.

Senator TAFT. He does not have to know the law for it to be willful. He may inadvertently do the act, but if he willfully does it and that act is a violation of the law, he has violated the law. You are presumed to know the law. You may not know the facts. If the act is willful, it is a violation of the law, a willful violation of the law.

Senator HUGHES. I have never heard any such construction of "willful" as that.

Mr. SCHENKER. Paragraph (f) of section 17, on page 39, merely provides, in substance, that you cannot have a provision in the charter or other fundamental or basic documents giving you permission to violate any rule or provision of this act. Paragraph (2) of that subsection merely says that you cannot give yourself a broad exculpatory clause with respect to any act that is covered by this bill.

Senator WAGNER. It is a good deal like the trust indenture act?

Mr. SCHENKER. Yes, sir.

Senator WAGNER. How much longer do you need, Mr. Schenker? I will tell you why I am asking the question. The Senators will have to leave soon, because there is a vote to be taken.

Mr. SCHENKER. Why can we not finish this one, and section 18, covering capital structure?

Senator WAGNER. Very well.

Senator TAFT. Does that provision require a company to amend its existing charter? [Reading:]

> After one year from the effective date of this title, it shall be unlawful for the charter, certificate of incorporation, articles of association, bylaws, or trust indenture of any registered investment company—

to do certain things. If they do not amend the charter, then they are liable to 2 years in jail and a $10,000 fine. Are you not going a little far on that? You might provide that no charter provision shall exempt the company from the provisions of this law. But to say that it is unlawful for a charter to contain such provisions, seems to me to be going rather far.

Mr. SCHENKER. That is an excellent suggestion. But what is the effect of stating it that way? If it says that it shall not contain such provisions, what sanction do you have if they do not take them out? You can do either one of two things: You have either got to make it unlawful or say that if the charter has such provision it shall be ground for the denial of registration of the company. What sanction would you use to compel the elimination of exculpatory clauses or the elimination of any provision which authorizes them?

Senator TAFT. I would say that it would simply nullify that provision of the charter so far as interstate commerce is concerned. I do not quite see how you can do it.

Mr. SCHENKER. Your approach would be, then, Senator, that any provision which exculpates the officers and directors or tends to authorize them to effect any transaction——

Senator TAFT (interposing). No provision in the charter shall prevail over the provisions of this act. Of coruse you will not only have charters, but you will have State laws specifically providing that certain rules shall apply to corporations. Your setting aside those State laws would depend upon Federal jurisdiction. That just occurred to me as you were going over it.

Mr. SCHENKER. Paragraph (g) of section 17 on page 40 merely says that at some subsequent date the Commission can make rules and regulations with respect to requiring the investment companies to give the custody of their securities to a bank or trust company. There is no provision at the present time for that. That is a matter of some consequence, Senator, because—if you recall the case that Mr. Smith gave of this old New England banking firm—that banking firm, which was in control of an investment company, was a depositary of the securities of an investment company. The banking firm gave a certificate to the auditor that it had control of the securities, when the fact of the matter was that the banking firm, being broke, had hypothecated the investment company's securities with a bank for the banking firm's own personal loan.

In that same picture the banking firm needed funds. It took two or three million dollars, I forget which, from the investment company and issued its own certificates of deposit. When we looked at the balance sheet of the investment company it said "Certificates of deposit $3,000,000." A person would assume that they had the money with the Chase National Bank, but it was the investment banking firm's own certificates of deposit that were issued.

Senator HUGHES. Why could not that be met by having the banking commissioners have control over it? Would that precaution go too far?

Mr. SCHENKER. You might get a conflict of jurisdiction between different agencies.

Senator HUGHES. Insurance commissioners have control over deposits of insurance companies.

Mr. SCHENKER. We still have not recommended that it is necessary, at least at this time, to go so far. If any abuses develop, we can come back to Congress and say that we found that situation.

Paragraph (2) of subsection (g) of section 17 says that in the future, if the situation is such that the protection of the investors requires it, the Commission may make rules and regulations with respect to bonding employees. Most of the reputable ones, in fact, nearly all of them, do have that situation. The fact of the matter is that if

there were bonds on the officials in connection with the Continental Securities Corporation they might have got part of their money back.

That is all that that provision means.

Paragraph (h) is a purely technical situation which says that the provisions of this section shall be applicable to those companies which sell investment trust certificates on the installment plan. The language of the previous part of that section is not sufficiently comprehensive to encompass that type of business. So we say that affiliated persons of these institutions shall be subject to similar provisions.

Mr. Smith would like to discuss capital structure. He may be able to clean that up pretty quickly.

Senator Wagner. You can go on. I think the bell will ring at any moment.

STATEMENT OF L. M. C. SMITH, ASSOCIATE COUNSEL, INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.—Resumed

Mr. Smith. Congress told us to look into these capital structures of the various companies, and we did. We made a very careful analysis of a great many securities. We came to the deliberate, carefully considered conclusion that there should be only one class of stock for investment companies that are formed hereafter or are hereafter issued by existing companies. If they want to issue further securities, they should only be common stock.

We came to that conclusion as the result of a number of considerations, and I shall touch on some of the principal reasons, if I may. A senior security of an investment company is, in many ways, comparable with a fourth or fifth mortgage. Take, for instance, the North American Co. system, that company has quite good operating utility companies, as I understand it. There are the bonds of the operating company; then the bonds of the North American Co., which are a second mortgage, in effect; and then there are bonds of a company like Electric Shareholdings which are held in turn by Central States which, in turn, has issued two issues of debentures and four issues of preferred stock on top of that. So that those senior securities really are equivalent to fourth, fifth, or sixth mortgages.

To let a company borrow money from the public, in effect, on that type of security seems to us unsound.

Let us see what happened in Central States. In 1929 they had $5,000,000 worth of debentures outstanding. They had $350,000,000 of assets, mainly the stock of North American Co., which is a pretty sound holding company. In fact, it is one of the outstanding ones. Yet even with that investment up to 1939 those debentures were only worth 46 cents on the dollar. That means that the senior securities of investment companies are secured by common stock which fluctuates widely. They have terrific fluctuations and are not, in our opinion, a sound basis for the issuance of senior securities.

Take the market experience of those common stocks of investment companies; that is, the common stocks which had senior securities outstanding ahead of them. A dollar invested in those would be only worth 5 cents today, whereas a dollar invested in companies with

only common stocks would be worth 50 cents; that is, from 1929 to 1939.

That means that the common stock is speculative. It is not an investment security at all. It is a speculative security which gyrates up and down. It goes up and down three or four times as fast as the other securities.

Then, taking the senior securities, we find that as to a great many of them we have a large amount of arrearages. For instance, in 1939, out of 68 issues, 40 issues were in arrears—something like $78,000,000. A great many of those senior securities are under water, which means that there are not enough assets to cover them.

Out of 69, there were 23 that were under water. That is not surprising when you consider that most of these investment companies are based upon common-stock investments which have decreased to about one-seventh of what it was in 1929.

So on that basis alone, if you wanted to be guided by that experience, you should not issue senior securities in an amount more than is necessary for protection, which would be in the amount of 10 percent. And that is not the only factor.

Senator Taft. Of course, if you are relying on 1929, you should not issue any securities at all or buy them. I mean, you had an extraordinary situation. I more or less am in sympathy with the idea, but I do not see why a security up to one-third of the value is not a reasonable sort of provision. I do not like a complicated system, but, after all, some people do want a little less risk and some people want a little more risk.

Mr. Smith. I had that approach, Senator. The more I considered the various reasons which I am going to refer to, the more I became convinced that there should be only one class. A senior security, supposedly a riskless security, has so much risk in it, has so many inherent defects, so many objections, that even one-third or 25 percent, as has been suggested, is permitting a security to be sold under the guise of the safety of seniority, when in fact it does not have it.

Senator Taft. Of course it does not have it, but, on the other hand, you buy it only to have a larger rate of return. You might buy a preferred stock in a perfectly good utility company. Presumably, the market would adjust the rate you would have to pay on that senior security——

Senator Hughes. Why does an investment company need other than one class of stocks, anyway? They are going to sell it to the public to get money.

Mr. Smith. That is the point. There is no economic justification, whereas with a utility company you have real reason for it.

Senator Hughes. You have real reason in an ordinary company; it is only to get capital.

Mr. Smith. It is just to get capital, and we have found in a great many cases it is to get capital to establish a margin account for the common stock, and you have an inherent conflict——

Senator Taft. I do not quite see the difference between permitting a man to buy preferred stock or a bond in a company that depends on securities and a company that depends on property and earning power. You have less chance of appreciation. On the other hand, you have a little more security. I had never thought preferred stock was a particularly good investment, but people do think so; they differ,

and I do not see the difference between an investment company and an industrial concern.

Mr. SMITH. I would like to point that out to you, because I think there is a big difference. Take the preferred stock of your industrial company. In the ordinary case you will find that they cannot issue that preferred stock until there are two or three times the coverage for it. They are right at the source of the earnings, whereas the preferred stock in the investment company is subject to all the senior charges. In the industrial company it only gets what is paid out in dividends, and those dividends over a period of years, even with capital gains, have not been sufficient to pay—since 1878 I think we figured out the greatest amount they could pay was 4 percent, assuming a 2 percent capital gain. For instance, in the year 1938, out of 71 companies examined, the average earnings were 2.47 percent.

Senator TAFT. You are just saying preferred stock is not a good investment. After all, that, it seems to me, is for the investors to decide. I do not quite see any harm done by a reasonable amount of senior securities. I do think if you limit it to a third——

Senator HUGHES. Is not the object of this legislation to look after the investing public?

Mr. SMITH. May I say, sir, if you have an established record over a period of years which shows that they cannot earn their keep, to permit people to sell senior securities on the ground that they are senior, when in fact——

Senator TAFT (interposing). I do not agree at all. Those records are open to everybody. Everybody can buy them. If you can sell that security it seems to me it is a perfectly proper thing. I do not think it is our function to say, "Here is a security which is not likely to work out—it may—so we won't let anybody sell it," even if it is not necessarily so, if the thing works out as it should. Preferred stock in an investment trust should not be sold unless you could show from the average earnings of the kind of stocks you are investing in that you have coverage for your income. You had extraordinary cases in 1929, of course, but I think sound investment in preferred stock in an investment company, unless you could show average dividends of at least twice what is needed——

Mr. SMITH (interposing). I defy you to show a single year where you can show that, and they did sell them and have sold them on the promise of capital gains. They do not disclose what the actual earnings have been. Our records show that over a long period of time they cannot earn their keep. That is just one argument. I have some more.

Senator TAFT. If we are going into the business of the S. E. C. saying that "certain securities shall not be sold because we do not think they are going to earn what they think they are going to earn," then we are going a long way beyond where we have gone before. The S. E. C. Act does not do anything like that.

Mr. SMITH. No. Of course, the Holding Company Act does, as a matter of fact, but all we are saying is that we are trying to prevent what, to my mind, seem to have been frauds on the investor. In other words, you get a gold brick that is sold and it turns out to be just a brick.

Senator TAFT. I would think that a limitation of one-third would be sufficient to protect the ordinary thing that you can foresee.

Mr. Smith. That is not what we found according to our experience.

Senator Taft. These things were before 1929, when it went down to one-fourth, no matter what security you bought; you lost three-fourths of your investment. You had that situation because of the tremendous drop.

Mr. Smith. In 1929 when these securities were sold they were not earning their keep then. For instance, I have the testimony of one of these reliable banking houses that although they were paying 5 percent, they were earning only 2 percent. They said they had to go into speculative securities because they had to earn the money for the senior securities. It has that effect on the management policy.

We have found continual conflict between the senior and junior securities, where the junior securities are interested in appreciation and the senior securities are interested in safety. Yet the safety factor is entrusted to the very people who are interested in speculation.

Senator Taft. Of course, that is true of every industrial company in the United States. Every company is run by the common stock holders, who have an interest in profits and in building up their companies and being a little more speculative than the preferred stock holders would like them to be. That is true of every company.

Mr. Smith. I think it is more so here, because if you buy into a utility you know that that company is going to be in the utility business. You can predict on the basis of the earnings of that company over the past 20 years. You have some possibility of knowing what that company is going to do.

Senator Taft. Not if the Government is building a plant next to you.

Mr. Smith. Nevertheless, you have, in due deference to you, Senator——

Senator Taft. We are considering now a bill to extend the Bonneville power lines, that will cost us $5,000,000, paralleling two existing utility companies. There is not a company where you have not got a risk.

Mr. Smith. In the T. V. A. area they increased their business. I think the operating companies down there had a tremendous increase since the T. V. A. came in.

Senator Wagner. That is my understanding. If you try to change it you will hear from the people down there. Go down there and propose a change and see what will happen.

Senator Taft. I am only saying that a utility business is subject to the same risk that an investment trust is subject to and that you have the same tendency on the part of the common stock holders to take a chance.

Mr. Smith. You cannot change your business in the utility. In the investment company we have found them shifting overnight. Suppose they go into insurance and they have senior securities outstanding. Suppose the wise policy is to stay off the securities for a year. Take the situation today, with the war. You have a constant demand to earn for your senior securities. What are you going to do? It hinders your investment policy.

Let me go on with a few more instances. As a lawyer you have drawn various trust indentures. You know the various provisions. Take the touch-off clauses. We have one group of witnesses who say you can protect senior securities if you put in touch-off clauses.

That means that securities will be sold out at a certain time if there are touch-off clauses. If they fall below a certain percentage of recovery, if you have $1,000 of bonds outstanding and only $1,500 to cover it, then the trustee must take action.

All of that requires a great deal of complicated legal rigmarole, and I think if you try to write an act which will give any protection or see that there is any protection for that security you will get an administrative act that will be a headache, and I personally do not think it is worth it where there is no economic justification.

I can give you people in the industry who will testify that touch-off clauses—and Mr. Bailie testified to that—is an instrument of the devil. He says it is a sword of Damocles over your head all the time.

Then we have instances where they have these touch-off clauses and they have evaded these protective provisions. No matter how well drawn they are, we have instance after instance where they evaded the so-called protective conditions. When the storms come and the winds blow the senior security does not turn out to be a senior security at all, but turns out to be in a tough spot.

Senator TAFT. I would rather differ with you, because you had extraordinary conditions in 1929. I think a preferred stock representing one-third of the value of the securities would be a safer proposition than the preferred stock in an industrial company of the same volume, because when an industrial company goes broke, it goes broke, whereas securities, if they are diversified enough, at least, ought not in the long run fall below a third of the value at which you buy them.

Mr. SCHENKER. Senator, we explored your idea of trying to see if we could not make provision for senior securities in the investment company. The fact of the matter is that in Great Britain they do have senior securities in the investment company, but, traditionally and historically, what do they do? They balance their portfolio so that the investments correspond to the outstanding senior securities. They have a certain amount of debentures, preferred and common stock. Their portfolio will have a comparable amount of debentures, preferred and common stock. That was to assure the debenture holder of the investment company that he is going to get an income which will meet his obligations.

The fact of the matter is that in this country, regardless of what the capital structure of the investment company has been, the average investment company, throughout its entire period, has been 80 or 90 percent of common stock. As a result you have this situation: Take an industrial corporation. They will not issue debentures unless they have an assured income, as in a utility or in a railroad, and even with the railroads they were disappointed after awhile. They won't do it unless there is an assured income with which they can meet the fixed charges of the debentures.

What is the basic asset of an investment company? It is common stocks upon which they may get dividends, or they may not get dividends, although in some respects, Senator, and I agree with you, a debenture in an investment company may have more desirable attributes than a debenture in an industrial corporation, because if an industry goes broke the debenture holders are left with bricks, boilers, and railroad tracks that they cannot make a nickel on. In an investment company you have marketable securities that you can realize on.

To my mind, you do not sell senior securities on the anticipation that you are going broke. If the company goes broke you can salvage a little.

I think you have got to look at the problem from the point of view that you expect the concern to be a going concern, and therefore we say that there should be one class of stock.

Now, we explored your idea, Senator, and what problem does it create for you? Of course, you said you would have a certain ratio of 30 percent in senior securities so that there would be adequate coverage in the first instance. Then would you make this provision in the senior securities? Let us take the case of a company in the event it was under water. Would you say they could issue one class of preferred stock or would you say, "Let them issue 1, 2, 3, or 4 of preferred stock?" Would you let them issue convertible preferred, convertible preferred 7 percent, convertible with optional warrants convertible not with optional warrants? Then would you say yes with respect to 30 percent of your issue that you can issue class A common, class B common, and so forth, debentures 54, debentures 64? You have that tremendous problem of trying to circumscribe and hedge the whole business. You would not countenance a situation such as we found, where the debenture holders put in $5,000,000 and the common stock holders $100,000 and that——

Senator Taft (interposing). No; but I should think a provision of not more than one would be enough, without the rest of it. I do not feel strongly one way or the other. I do not see any reason for not having it. On the other hand, I do not see that it serves a good purpose.

Mr. Schenker. Our concept of an investment company is that it is a mutual enterprise. The stockholders being on a parity, there ought not to be any conflict between the securityholders of that type of institution. This ought to be a mutual enterprise, with one class, simple structure, no different than a bank, no different than an insurance company, no different than any other type of financial institution. They are all partners in a common venture. They all stand to gain or lose. There is no overreaching. There is no necessity for protection in situations where the common stock is under water, and the funds really belong to the common stock holders.

When you get into the debentures your problem becomes terrific. If you issue debentures, then, in my opinion, Senator, it may constitute a fraud, because when a person buys a debenture he thinks it is collateralized. He thinks it is secured.

Senator Hughes. He thinks it is a sort of bond.

Mr. Schenker. He thinks it is a bond.

Senator Taft. Well, it is a bond, is it not?

Mr. Schenker. It is a bond——

Senator Taft. I mean, secured on marketable securities, presumably.

Mr. Schenker. That, Senator, is predicated on the assumption of either one of two things: Either that the assets of the investment company have been collateralized to secure debentures, which is never the fact; or you get what we call the touch-off clause, which requires the maintenance of a certain ratio between the assets and the outstanding debentures; or you take the other alternative where the debenture has no protective feature at all. In the last case you are

selling him an unsecured promissory note. He says, "I promise to pay you blank dollars at maturity."

The industry finds itself in this anomalous position. It says, "Let us issue debentures, but, for Heaven's sake, don't let us put any touch-up clause in it."

Why? Because it is a sword of Damocles over his head. His whole investment policy is not dictated from investment experience but from the exigencies of the situation that if he does not have some provision to make money fast his touch-off clause will be on him, there is a default, and the debenture holders will get the control of the company. So the unanimous opinion was, let us issue debentures, but do not require us to put any of these protective features in.

Under those circumstances we say, Senator, if you are going to sell to the average small buyer a debenture and then sell him an unsecured promissory note with such assets which fluctuate with such great variety, just make the provision that you will make him issue debentures to the extent of 33⅓ percent of the company's assets. We feel that if you weigh it in balance, the thing to do is to cut the Gordian knot once and for all and say, "Let us make a simple structure, everybody on a parity, and a person would be able to ascertain what his value is, and everybody will have an equal participation in the selection of the management." You have to weigh the scales in those situations.

I am not saying that some preferred stocks of investment trusts are not good investments, but in all these situations you have got to take the advantages and you have got to take the disadvantages. From our study, and we have written a 500-page report on that, we are firmly convinced that the disadvantages inherent in senior and junior capital structure companies so far outweigh the advantages, that there is no question about it. Where you try to limit the number of different classes outstanding, try to legislate or regulate with respect to what protective features they should have, we say they should be like a mutual savings bank—one class of stock, no conflicts, everybody has a pari passu share in the voice of the management.

With respect to the companies in existence, Senator, we do not touch those. We say if you have preferred stock, that is perfectly all right.

Senator Taft. What about (d)? Do you touch it in (d)?

Mr. Schenker. Which is (d), Senator? That is in connection with redistribution of voting rights. That is not going to hurt the senior security holders. The fact of the matter is that the whole purpose of that particular subsection is to give them some additional rights in those circumstances where he really owns the company and the fellow who has common stock not only has no asset value but may be 50 cents a share under water and is running the company without any participation in the senior security holdings. That subsection will not take away any rights from the preferred stock holder. The whole purpose of that is to give the stockholder additional rights.

Senator Taft. How do you think that can be done constitutionally? I do not want to raise a constitutional question at this time, but how can that possibly be done?

Mr. Schenker. That is not an easy question, Senator, and we hope to be able to submit a memorandum on that, but the only point I am making at this time, Senator, is that I do not think you can

quarrel with the principle that an investment company which has fluctuating assets should not have senior securities in its structure. You might, with a great deal of effort and labor, try to model the preferred stock for that type of company and try to circumscribe and hedge it, but once you are trying to do that, necessarily they will say, "What logic is there in having one class of stock if I am going to limit my senior securities to 33⅓ percent of my assets"——

Senator TAFT. I think there is logic. I don't think we ever got in trouble with the other kinds of companies. It was when they began to branch out and these corporation laws permitted all kinds of securities that we got into trouble. It seems to me possible to allow one class of prefered stock, not to exceed one-third of the total, which is about as we had it in Ohio away back in the old law. I do not think we ever had any trouble with that. I agree with you. I do not like all these different——

Mr. SCHENKER (interposing). What happened was we have found every time you get the pyramid structure and pyramiding takes place, where you have more than one class of stock, there is no fun in paying a dollar to get control of the other fellow's assets. The only fun in getting control of it is where for a relatively small amount you can get control of the senior security holders' money, and in every case where there was a selling down the river there was a case of the common stock holder as selling the senior securities' money to somebody else.

What we are afraid of, Senator, is this, and I am not being critical, and I suppose you are going to hear a big defense of this. Take a look at the Tri-Continental set-up today. That is the type of capital structure that you may get into unless you take the most meticulous care in your statute to limit it to one class rather than try to limit it, in addition, to having a certain ratio to the outstanding securities. If I may be a little slangy about it, we do not think it is worth the fuss to try to make an elaborate provision, which will probably be page after page, to provide for a situation where a company may want at some subsequent time to issue a little preferred stock.

We say, considering the elimination of the conflict of interests, considering the other protection, considering the advantages that may flow from the additional capital structure provision, that for this type of business, just like for a bank and insurance company, it should be this way.

If the senior security holder has senior securities he may stay with them, but as far as the future is concerned, we think there should be one class stock company.

With respect to the going concerns, if they want to raise more capital, the only thing this provision does is to put more "cushion" behind the senior security. The senior security holder is the individual looking for safety. He says, "I am not interested in making a bunch of money. All I want is my principal back and a moderate return," and we say that is what he ought to get, and if these companies want to raise more capital, they can do it. All they have to do is to increase the common stock and they will increase the "cushion" behind the senior security holder.

We say, in addition, to protect the senior security holder who is investing in it for safety he ought to have something to say in the management of it, if he owns the whole company and the common

stock holder has no financial interest in the company at the time he is exercising control.

Senator Taft. Do you say as to (d) you are going to submit a brief as to how it can be constitutional to require by your order that every company "take such steps as are necessary or appropriate to effect an equitable redistribution of voting rights and privileges"?

Mr. Schenker. We will prepare a memorandum on that.

Mr. Smith. That is in the Holding Company Act already.

Mr. Healy. I think a brief was prepared on that point when the Holding Company Act was passed by Congress.

Mr. Smith. We have a number of instances of this where they had no control and no investment at all.

Senator Taft. I think it is a real abuse, as far as that is concerned.

Mr. Smith. There is just one other point that Mr. Schenker did not make, which always appeals to me. When a banker or broker lends money (and that is what happens when an investor buys preferred stock), it seems to me, he has a broad power of attorney signed. It gives him every power under the sun as to selling out, demanding more collateral, and he has a margin to protect himself, and you know how they sat up at nights when the market was going bad to demand more collateral. That senior security could be sold to an investor without the same protection that the trade demands, particularly in view of the improbable ability to even earn their keep or to be protected, even on the one-third basis seems to me unsound. Take that over a long period of time; you can't justify it on past experience. It may be different in the future.

I agree with Mr. Schenker that it is not worth the risk of it and all the dangers, particularly when it serves no economic function except possibly it helps to give something to people to sell, and we have had a lot of abuses from people taking advantage of emphasizing the safety and the senior nature. It is bound to be confused with a security of safety.

Mr. Schenker. May I make one other observation? Of course, I do not pretend to be an expert with respect to this matter. In some respects I may be a little naive, but it seems to me that this whole problem of senior securities in investment trusts is kind of academic. The fact of the matter is, as I recall, virtually all of the preferred stock are selling at a substantial discount. Why would anybody pay par for preferred stock of one company when he can go out and buy preferred stock of many companies at 70 cents on the dollar?

If we were convinced that we were impeding the raising of capital for this, that, or the other company, we would say, "Maybe it is worth while. We will stew around and give them a chance to sell preferred stock."

They could not sell preferred stock today, nohow, because you can buy substantial preferred stock at 30 percent discount. You can buy preferred stock of many companies at 70 cents on the dollar. Who is going to pay the full dollar on a new, untried venture?

Therefore, in many respects, for the immediate future the problem is academic, and so we say, let us make them simple and let us not get tricky—simple company, one class of stock, a mutual aspect, everybody sharing the risk, and everybody sharing in the profits pari passu, and everybody having an equal share in the profits of the company.

We attempted to fuss around and see if we could arrange some formula saying 33⅓ percent. We tried to make requirements similar to those of the Federal Reserve Board, which requires 50 percent. You always run into the problem, Well, is it going to be 1, 2, 3, 4, 5 class? Are you going to have any protective features? Are you going to have touch-offs?

For all those reasons we were compelled to recommend to the committee that there be in the future simple, one-class companies.

Mr. Smith. In connection with the existing senior securities, there is one other provision in section 19 (b), where we attempt to give some protection to the existing companies and say that no dividends shall be paid on a preferred stock if there is not a 200 percent coverage of that preferred stock—that is, no dividends paid to the common stock underneath. In other words, to prevent taking away the assets under the existing senior security by the payment of dividends, we have a provision that is common. That type of protective provision is common.

There was one big investment company where the stock exchange said, "You can't pay any dividends on your preferred stock unless there is a 200 percent coverage."

I have a number of other examples where they used that type of protection, and the percentages vary—200 percent for preferred stock and 300 percent for debentures. It was a matter of judgment as to what point that was going to be.

Senator Hughes. How are they going to get along with the fact that their charter may provide something else?

Mr. Smith. The charter may permit them to do something——

Senator Hughes. I am speaking of the past, one that is already in existence.

Mr. Smith. This applies to them, and as to them we say that they cannot, even though the charters may permit them, pay dividends or make improper payments of dividends to junior and senior security holders. We say that whether their charter permits them to do it or not, if they have got less than $2 of coverage for every dollar they cannot pay dividends to a junior security holder. They can pay it on their own, but not on a junior.

Mr. Schenker. When I examined Mr. Odlum, in connection with the Atlas-Curtiss-Wright merger, I asked him if there was some reasonable ratio between the senior securities and the common stocks, and the other day he came to me and he said, "Maybe you are right, Dave," and that whole merger between Curtiss-Wright and the Atlas Corporation has for one of its motivating reasons the fact that Mr. Odlum wants to get the preferred stock out of the capital structure.

Take that type of company which does not invest in securities listed on exchanges primarily, but goes into the special situations. Mr. Odlum had $20,000,000 of his funds in the U. P. and L. and he was not receiving a return until it went through reorganization. That preferred stock was the darndest headache in the world to him. He could not meet the dividend payments. He says in that type of company, where you are going to perform an economic function and make capital available to small business, how are you going to assume to pay dividends on the preferred stock when you make your money not from a constant return but after the wind-up of the whole transaction and make it in one lump sum? So that the Atlas is deliberately getting rid of its preferred stock.

I know of another situation of a similar nature where that company is determined to get rid of its preferred stock. We have repeated examples and testimony where the people said that at the worst time in the market they had to liquidate their portfolios because they had to raise cash to meet the interest payment on the debentures. If they did not have debentures the history of their companies would have been different, they said.

You have all the complicated conflicting factors in the capital structures that have more than one class of securities, and I say if you weigh the scales and balance them as to the advantages and disadvantages, the balance is definitely in favor of one class of stock.

Mr. Smith. Section 19 (*a*) deals with dividends.

Section 19 (*a*) (1) deals with payments of dividends from such other sources, and the first part of (*a*) (2) is a provision that, I believe, the New York Curb adopted a long time ago. It says if you pay out of anything but earnings you have to disclose it. Where these open-end companies pay out capital, and many of them do pay out distribution of capital, particularly in connection with the tax law and otherwise, we say you cannot pay out your capital and then not let the man reinvest it and charge him a sales load.

In other words, you cannot pay out the capital, and then he thinks, "Well, the company is doing very well and making money," and he puts it back again, and they take off 7 or 8 percent. You can keep going in a circle like that and gradually diminish the entire fund by taking 6 or 7 percent each time, as they do it.

I do not think there is any objection to that. As a matter of fact, one of the members of the industry suggested that this would be a very good measure.

Mr. Healy. May I interrupt Mr. Smith long enough to say that this provision was recommended by a majority of the Commission? Principally, speaking for myself alone, I was raised in a jurisdiction——

Senator Wagner (interposing). You are speaking of section 19 (*a*)?

Mr. Healy. Yes, sir. I was raised in a jurisdiction where it is against the law to pay dividends out of capital. I think it is a perfectly sane and healthy rule.

It is very late, and as I have to make a quorum at the Commission, since we only have four members now and one is away, I do not want to get into a discussion of my views at this late hour.

Senator Wagner. I think this is a good time to stop, anyway. It is getting near 5 o'clock. We are having a vote on the floor. We will resume tomorrow morning at 10:30.

(Thereupon at 4:55 p. m. an adjournment was taken until tomorrow, Wednesday, April 10, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

WEDNESDAY, APRIL 10, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, and Townsend.

Senator Wagner. The subcommittee will resume its hearing. All right, Mr. Schenker.

Mr. Schenker. Mr. Chairman, Mr. Smith just has a few words to add to his statement of yesterday evening.

Senator Wagner. All right.

Mr. Smith. I just want to say a few more words——

Senator Wagner (chairman of the subcommittee). I had been listening to Mr. Schenker and forgot that possibly you had not completed your statement. You may go ahead.

STATEMENT OF L. M. C. SMITH, ASSOCIATE COUNSEL, INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.—Resumed

Mr. Smith. I just want to say a few more words about this section 19 (a) of the bill; that is, in respect to dividends. We have provided in that section a moderate provision—that dividends can be paid out of capital provided they are allowable by charter and are segregated when paid.

Now, there are certain people who feel that dividends should not be paid out of capital at all or in no event if the capital is impaired. There is a good deal to be said for that point of view. I think Judge Healy would like to go into that in some detail when he has the opportunity. However, I think the rest of us feel that if you have a single-class structure—and there are other types of capital structures that must be covered, but I am referring more particularly to common-stock companies—if you have a one-class structure then the problems of dividends are much simpler. You do not have all the problems, as to whether it is fair to senior securities as to paying dividends in good times and slicing off the cream so that in bad times senior securities may be affected.

We have made this provision, which is comparable to the provisions of the New York Stock Exchange, to meet the situation, with

the further provision that if they do pay dividends out of capital the investor shall have the right to reinvest this capital without a load. Thus they can pay out of capital but must let him put it back again without taking out 6 or 7 percent for load. This provision was was made to meet situations which may and do arise and was suggested by one of the larger trusts. The phraseology may not be complete to meet the situation, but the principle is certainly sound.

I might explain that——

Senator TOWNSEND (interposing). Do you intend to justify the paying of dividends out of capital at all?

Mr. SMITH. Can I?

Senator TOWNSEND. Yes.

Mr. SMITH. Sir, take a one-class company which has invested in equity stocks, we will say it raises $40,000,000 today. That $40,000,000 by reason of fluctuations in the stock market may go down to $15,000,000 and may go up to $60,000,000. It is a very volatile fund.

I think there are a great many investors who want to have dividends paid out of capital gains. We have taken the position that it is all right if they are expressly allowable. On the other hand, I think there are a great many people who will tell you that that has worked a fraud on the investor and that no matter how you make it allowable to make payments of dividends out of capital or capital gains, the investor will think it is earnings and be misled by it. There are certain investment companies who have used that practice in their selling campaign.

However, we have taken——

Senator WAGNER (interposing). Mr. Schenker cited a case where $800,000 was taken out of assets to pay dividends, and apparently it was done to make the stock attractive upon the market.

Mr. SMITH. That is right. And there was one company that promised a 5 percent dividend right along, forever and ever, whether earned or not. You will find that a great majority of these investment companies do in fact pay dividends out of capital even though the capital is impaired. Section 19 (a) is a provision that we have thought might cover the situation, but it would not bother me for you to make it more rigid.

One more point: In regard to existing senior securities we do have here still the problem of existing senior securities. Along that line we have adopted one provision—that if dividends are paid to junior stocks there shall be an adequate coverage, at least a minimum coverage, of assets for the senior securities. In other words, if there is $100 of preferred stock outstanding we have said: You cannot pay any dividends on the common stock unless there is $200 of assets to cover every share of preferred stock; otherwise you might be draining off the assets so far that when bad times came it would be unfair to senior securities.

Let us take the Tri-Continental Corporation charter. It says:

> No dividend shall be declared upon the common stock unless at that time the net assets of declarant, as determined and computed in the manner provided in the agreement of consolidation, as amended, shall be at least 200 percent of the aggregate amount (exclusive of dividends accrued or in arrears) to which all shares of the preferred stock and all shares of stock on a parity therewith, then outstanding, shall be entitled as a preference over the common stock in the event of any voluntary or involuntary liquidation, dissolution, or winding up of declarant.

I can show you a number of similar provisions of that sort. The New York Stock Exchange, in the case of one big trust, had a similar provision of 200 percent for preferred stock. We have made the provision of 300 percent for debentures because they are further up the line.

Senator WAGNER. But, I take it, that problem does not arise if we provide only for common stock.

Senator HERRING. And that provides for existing common stock.

Mr. SMITH. That is to take care of companies that are now existing. I showed to you Senators yesterday, although I did not introduce it in evidence, company after company with control stock where 95 percent of the voting power is in stock that has no asset value at all and probably won't have any asset value for years to come. It is to prevent that control from being misused.

I do not say that it is adequate to meet the situation, but it is one protective provision. It may be we ought to have more on that.

Senator WAGNER. If there were an actual prohibition against paying dividends except out of profits this question would not arise, would it or would it not?

Mr. SMITH. This question would not arise then. That is right. But you might interfere with a fairly common practice.

Senator WAGNER. I understand that. There are two sides to the question.

Mr. SMITH. Yes, and it is a difficult question. I do not think we here have by any means met all the problems that can arise in paying dividends. I think Judge Healy may be prepared at some time to tell you why. I think he is interested in accounting methods which go back to what the original contributed capital was.

A difficulty with that situation is this: I know of a number of investment companies that have been organized with common stock, that started off with a deficit—had no asset coverage at all when formed. To base any historical value upon what the original contract was seems to me not to take into account the inherent difficulty, that the investor did not realize it was unfair to him. Also the stockholders have changed, in 10 years the original investors are out of the picture. It is not a realistic approach to the problem.

Mr. HEALY. Mr. Chairman, last night I hoped that this morning I could express myself on the subject of this section dealing with dividends. But I was pressed for time overnight, because I was needed to make a quorum at the Commission, and there were a number of opinions to be written, so that I do not find myself at this time in position to discuss it as I would like to. I think Mr. Smith and I do not understand each other on the subject of dividends, and I would like the subcommittee to postpone my discussion of dividends until a later time. My difficulties center around paying dividends out of capital. I am also not convinced that you can make one rule on the subject of dividends that would apply to all these different types of investment companies, regardless of whether open-end or closed-end, or regardless of whether they have senior securities or not.

May I leave it there for the present?

Senator WAGNER. Yes; is that all, Mr. Smith?

Mr. SMITH. Yes, sir.

Senator WAGNER. Thank you very much.

Now, Mr. SCHENKER.

Mr. SCHENKER. Mr. Chairman, Mr. John Hollands, who has assisted us in the drafting of the recommendations of the Commission, will take up some of the subsequent sections.

But before we do that I would like to introduce into the record the chart of J. & W. Seligman & Co. group, which we discussed yesterday. I understand they are examining it for any inaccuracies, but I would like to introduce it subject to correction by them.

Senator WAGNER (chairman of the subcommittee.) It may be made a part of the record.

(The chart headed "J. & W. Seligman & Co. group, December 31, 1939," is here made a part of the record.

Mr. SCHENKER. There is one other thing I would appreciate being done, and that is, for the record to indicate that in my discussion of the Harrison Williams' group of investment companies and the Central States Electric group set-up, that my discussion as to the extent of Mr. Williams' ownership of Northern States Power through his control of Central States was as of December, 1935. There have been some changes since because of the Utility Holding Company Act. I think he has redistributed, or may have liquidated, some stock so that he would not be considered a holding company under the 1935 act.

Now, if Mr. Hollands might be heard.

Senator WAGNER (chairman of the subcommittee). Give your full name, Mr. Hollands.

STATEMENT OF JOHN H. HOLLANDS, ATTORNEY ON THE STAFF OF THE SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Senator WAGNER. What page of the bill are you looking at?

Mr. HOLLANDS. Mr. Chairman, I will start with section 20, on page 45.

Senator WAGNER. All right, Mr. Hollands, you may proceed.

Mr. HOLLANDS. Subsection (a) of section 20 contains the proxy provision that is customary in legislation administered by the Commission. Those companies that have securities listed on stock exchanges are already subject to a similar provision in the Securities and Exchange Act of 1934. This provision would make all investment companies registered under this act, subject to the same requirements.

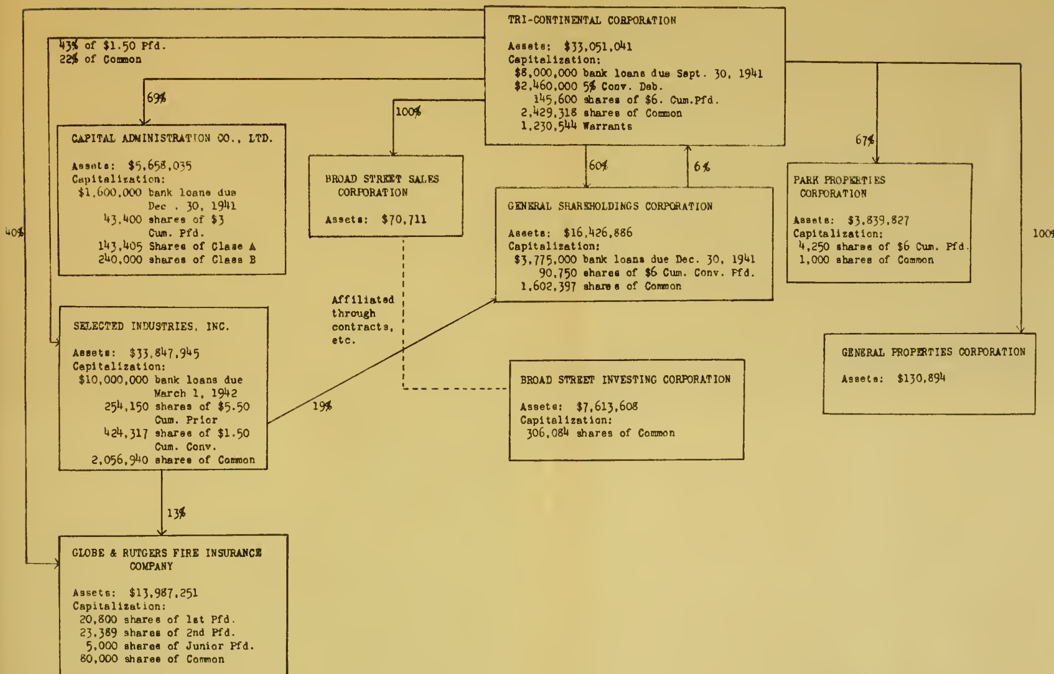
The section has been changed slightly from the earlier sections in point of language to make the provisions a little more definite in the light of the experience in administering other proxy sections. It has gone about as far in that direction——

Senator TOWNSEND (interposing). Do you mean that you have changed it since the writing of this bill?

Mr. HOLLANDS. No. I say that this section of this bill is modeled on other proxy sections in other statutes. In the earlier acts it is slightly different in language. The effect of the changes in this bill is to narrow rather than to enlarge the power of the Commission, I should say.

Subsection (b) prohibits a public offering of voting trust securities if the underlying securities in the voting trust are those of a registered investment company. It permits a private offering of voting trust certificates, which means that if a family, for example, wanted to turn

J. & W. SELIGMAN & CO. GROUP, December 31, 1939
(Maximum investment of J. & W. Seligman & Co. in Tri-Continental Corporation, $2,500,000. Holdings of J. & W. Seligman & Co. and partners in Tri-Continental Corporation at December 31, 1939: 8,600 shares of Common stock and 36,122 Warrants.)



over the voting power of the family holdings to one member of the family, it would be quite possible to do that because that would simply involve a private offering of voting trust certificates. It was felt that the use of the voting trust as a control device in these companies has no justification.

Subsection (c) prohibits what is known as cross-ownership or circular ownership. That exists when you have two or more companies. Let us take the case of company A and company B: If company A owns some voting securities in company B, and company B owns in turn some voting securities in company A, the result is to greatly dilute the voting power of other shareholders, and also to create a very complicated situation so far as ever seeing a clear picture of the companies is concerned.

Yesterday one of the charts handed up was that of the American Capital Corporation, where, if I remember correctly, there were three companies, and a ring-around-a-rosy arrangement.

This prohibition extends not only to cases where both companies are investment companies, but to cases where any one of the companies involved is a registered investment company. For example, in the Petroleum Corporation case the Petroleum Corporation owned a sizable block of securities of an industrial corporation which in turn owned securities of the Petroleum Corporation. Will you give the figures on that, Mr. Schenker?

Mr. Schenker. In the Petroleum Corporation situation, the Consolidated Oil Co. owns approximately 40 percent of the total outstanding of the Petroleum Corporation, which is an investment trust. The investment trust in turn owns about $1,200,000 of the total outstanding shares of the Consolidated Oil Co., which is approximately 9 percent of the total outstanding of the Consolidated Oil Co. So you have got the Petroleum Corporation owning a substantial or almost controlling block in the Consolidated Oil Co., and the Consolidated Oil Co. owning 40 percent of the Petroleum Corporation, and the remaining 60 percent being in the public's hands.

At one time the portfolio of the Petroleum Corporation had such a substantial block of Consolidated Oil stock in it that 80 cents of every dollar of that company was in Consolidated Oil stock. Even at the present time the Consolidated Oil stock held by the Petroleum Corporation is about 42 percent of the total value of the portfolio of the Petroleum Corporation—the investment trust.

I examined Mr. Elisha Walker, who was on both the boards of directors, and I examined Mr. Earl Sinclair on this situation; and it seemed to me at the time I examined them that the block of stock constituted about 70 or 80 percent of the total assets of the investment company.

I said to Mr. Walker and Mr. Sinclair, "Why don't you liquidate your Petroleum Corporation and declare a dividend with your Consolidated stock, which is virtually all you have, and therefore not subject to stockholders to a charge for an operating expense which last year was $80,000?"

They said, "We do not know."

I said, "Let me see if this is not the reason."

What would happen, Senator, if they declared the dividend in kind and liquidated the Petroleum Corporation? That means that the Consolidated Oil Co. would get back a very, very substantial

block of stock of its own company; they would get a block of stock which constitutes 5 percent of the total outstanding. Once that becomes treasury stock, the management cannot vote it; but by taking that block of stock and insulating it in an investment which the management controls, they can vote that 10 percent block of stock in favor of the management. We say, for that reason, that that sort of tie-up where an investment company has a big block of stock in an industrial corporation and the industrial corporation has a big block of stock in the investment company is a device for perpetuating the incumbent management, regardless of whether or not they are doing a good job, you see. So we have that situation, and in addition thereto you get this accentuated picture of earnings. If the Consolidated Oil Co. makes money, then the holdings of the investment company go up; and if the value of the investment company's stock goes up, then since the industrial corporation owns a big block of that investment company's stock, its earnings go up; and if its earnings go up, then the investment company's stock goes up. You get that vicious cycle there, and we say that as far as an investment company is concerned that situation should not be permitted to exist. At least you cannot create it knowingly in the future; and as far as the present situation is concerned, there is a time element that applies, specifying a time within which they can sever that relationship.

Senator WAGNER. Right at that point I was going to ask you a question. What is the public purpose served under the circumstances you just mentioned in having an investment trust at all?

Mr. SCHENKER. In our opinion there is absolutely no economic public service in that relationship. In fact we consider it a detriment to the public stockholders.

You see, the Consolidated Oil Co. may not wish to have the investment company reduce its block of stock in the Consolidated Oil Co., because the incumbent management would then be losing a controlling block of stock with which it could perpetuate itself. That may be to the advantage of the incumbent management of the Consolidated Oil Co. but it may not be to the interest or to the advantage of the large group of public stockholders who own 60 percent of the outstanding stock of the investment trust. It may be to the public stockholders' interest that they get out of the Consolidated Oil stock; yet because the Consolidated Oil Co.'s management has control of 40 percent of the investment company's stock, the probabilities are that they will not do it. They may reduce their position slightly, but not in a very substantial amount in the aggregate. You have this picture where at least half of the assets of the investment trust consists of the securities of another company. They are paying $80,000 a year for officers, to research and operating expenses, although the company is just sitting there with this one big block of stock. That is the story.

Senator WAGNER. Is Mr. Hollands going to explain just how, by these provisions, you are preventing that situation?

Mr. SCHENKER. He will explain the mechanics that we have recommended to the committee.

Senator WAGNER. All right.

Mr. HOLLANDS. Subsection (c) on page 46 prohibits acquisitions by a registered investment company of securities if as a result of the acquisition cross-ownership or circular ownership exists. The line is drawn at 1 percent of the outstanding voting securities of the other company.

In other words, even though the securities of the investment company are held by the other company, the investment company can acquire voting securities of the other company up to 1 percent of the outstanding voting securities of the other company—the purpose being to eliminate rather trivial cross-holdings.

The circular ownership problem is the same. The description here is somewhat complicated; but the result, I think, is to define the case of circular ownership as distinguished from cross-ownership. That is, where you have two companies, you have cross-ownership; where you have more than two—three, four, or five—it may run right around in a circle. For example, A owns voting securities of B; B of C; C of D; and D of A.

Subsection (c), as I have said, applies only to acquisitions. It prevents cross-ownership in the future, where it does not now exist, and it prevents the aggravation of any existing cross-ownerships.

Subsection (d) goes further and provides for the elimination of such cross-ownerships. It states that it shall be the duty of the investment company, where cross-ownership or circular ownership exists, up to this 1 percent figure, to eliminate the cross-ownership or circular ownership within 3 years after the effective date of this title.

Then it goes on to say, in the second sentence, that when cross-ownership or circular ownership accidentally comes into existence in the future—which is possible—the investment company shall be given a year's time within which to get out of that situation.

Now, Senator, both the 3-year figure and the 1-year figure are somewhat arbitrary. Perhaps there should be some flexibility there; perhaps the period is not right. I do not know. It is a very difficult problem to set a definite period and to say that that is absolutely fair.

Senator Townsend. What would be necessary after the passage of this bill, for instance, in the case of the Consolidated Oil Co., which you just mentioned as an illustration? What would it be necessary for them to do with their stock?

Mr. Schenker. All they would have to do is—instead of declaring a cash dividend—declare a dividend in kind and to give the stockholder of the investment trust his proportionate share of the stock in the Consolidated Oil Co. That is all, and that ends it.

Senator Townsend. It would not be necessary for them to sell their stock?

Mr. Schenker. No; they can declare it as a dividend.

Mr. Hollands. They have a choice of any method of doing it.

Senator Wagner. Then it will become a stockholder?

Mr. Schenker. They are now, Senator.

Senator Wagner. They are in effect; yes.

Mr. Schenker. We have other examples of this. For instance, an important case is a big chemical company in this country. We have not been able to ascertain who are really the individuals in Germany who have the controlling block of stock of this chemical company in this country. We examined the managers of the Domestic Chemical Company and they said, "Well, the stock of this Domestic Company is in the name of Swiss companies"—who are nominees; and we can never find out who are the German interests who own the Swiss nominees, who in turn control all the common stock of the domestic company, which is the only voting stock in that picture.

What do we find? Not only do the Swiss nominee corporations own all the stock of this American chemical company—and you can

see the significance of that in case of war or in connection with the matter of national preparedness—but this American chemical company owns the securities of some of these Swiss nominee companies and Swiss companies; and you have got that circular ownership in a situation where a substantial chemical company in this country is owned by foreign interests, and we cannot find out who the foreign interests are; and the State Department has been unable to find out who owns that chemical company.

I had Walter Teagle, the president of the Standard Oil Co., who is on the board of directors of the chemical company, make a statement; and he was quite cute about it.

I said, "Do you know who your boss is?"

He said, "No; I am on the board of directors."

I said, "Who owns your company?"

He said, "I don't know. It is in the name of some Swiss corporations."

That is the situation, and we think it is unhealthy.

Senator Wagner. Is there not a list of stockholders?

Mr. Schenker. No; we tried to ascertain in Europe who were the beneficial owners of the nominee corporations. This is the farthest we could get: We could get to a lawyer and his stenographer, who held the stock. Then we tried to follow it beyond that, but there was no provision in the European laws which would make available a list of the stockholders. So that today one of the biggest chemical companies in this country is controlled by foreign interests; and nobody, as far as I know, in this country knows who owns that block of stock. We examined the president, the secretary, and so forth. The fact is, however—and I am not saying that that is the situation at the present time—that originally the company's debentures were in effect underwritten by the German Dye Trust. Whether or not they are still in that picure, we do not know.

Senator Wagner. Mr. Schenker, just as a matter of information, I did not know that a foreign company could do business in this country unless the character of the business and those engaged in the business are disclosed.

Mr. Schenker. Yes. Well, you see, the American chemical company is a domestic corporation. In their registration statement with us they gave the names of the nominee companies who owned the stock; and we could not get beyond the nominee companies. That is the point.

Senator Wagner. The company operating here is an American company?

Mr. Schenker. Oh, yes; certainly.

Senator Wagner. But it is a company whose stock is owned——

Mr. Schenker. Held in the name of European nominees.

Senator Wagner. I see. However, it seems to me that even that ought to be disclosed, before they should be permitted to do business in this country; but that is another question.

Mr. Hollands. If I may, Mr. Chairman, I shall go on to section 21.

Senator Wagner. Yes.

Mr. Hollands. Section 21 deals with the subject of loans. Subsections (a) and (b) deal with loans by the investment company. Subsection (c) deals with loans to the investment company. Perhaps they could better be called borrowings. The problem with which

subsection (a) tries to deal is the problem of loans made for ulterior motives—not bona fide business loans. The obvious loans to "insiders" are prohibited by section 17, which was discussed yesterday. The company is not permitted to make a loan to an officer or a director.

However, there can be cases of loans to personal friends and other loans which do not have any reasonable business basis. Subsection (a) states a very rough rule of thumb for dealing with that. It says that no loan shall be made to a natural person, as distinguished from a corporation or other organization.

It is difficult to imagine a case in which an investment company, which is in no sense a small-loan company or a bank, need make a loan to an unincorporated person; and that will cut down to a degree the type of loans to which there is objection.

Senator WAGNER. If they are permitted to make loans at all, is it not less of a risk to loan to an individual, on whose liability there is no limitation and who may be responsible, rather than to a corporation which may have very little in the way of assets and, therefore, be irresponsible?

Mr. HOLLANDS. That is perfectly true, Senator.

Senator WAGNER. I do not know that distinction.

Mr. HOLLANDS. That is perfectly true; but there is this consideration: An investment company, if it makes loans, should make loans only to industry, only to industrial organizations of some consequence. Otherwise, it is not engaged in an investment business but is engaged in more of a personal loan business.

Senator WAGNER. Suppose I am an industrialist; I may not be a corporation. I am wondering about that distinction; frankly, it does not make sense to me; but you may be right about it.

Mr. SCHENKER. On that aspect, Senator, by and large we had the feeling that the making of loans is a function of commercial banking, and not of investment companies.

Senator WAGNER. I agree with you there.

Mr. SCHENKER. But we figured that in view of the capital market at the present time, if an investment company wanted, bona fide, to make a loan to a small industry or to take a participation in a promotional venture, then we felt that we should not prohibit them from doing that. What we have said is that if you tell your stockholders that you are going to go into the business of making loans to industry, then of course it is all right for you to do it.

With respect to the natural person, the individual, the person who is a big industrialist, I do not know of any such type of situation. However, if you wanted to get——

Senator HUGHES. What about a partnership?

Mr. SCHENKER. He could not make it to a partnership.

There is nothing to prevent the investment company from getting the accommodation endorsement or the guarantee of the individual; but what we wanted to stop is the type of case that we found—where personal loans were made to individuals who were close to the sponsors, or where loans may have been made for some ulterior motives.

Senator WAGNER. All right; suppose that individual, if he could not get it himself, were to undertake to organize a corporation, so as to be able to get it? As you said yesterday, it takes only about $100 or less to form a corporation. Under those circumstances, then, would they loan it to the corporation?

Mr. SCHENKER. That is why this section says "directly or indirectly" to a——

Senator WAGNER. Well, Mr. Schenker, I do not want to spend a great deal of time on that; but it really did not make sense to me.

Mr. HEALY. It seems to me that in an effort to meet and obviate the evil here the pronoun has perhaps gone a little far.

Senator WAGNER. Yes.

Mr. HEALY. I think we ought to consider perhaps some loosening of that provision.

Senator WAGNER. But right there if I may make an observation, Mr. Schenker said a moment ago that the investment trust may want to go into a venture or some promotion. Well, I have always understood—and if I am wrong, I have been going along with the wrong understanding from the very beginning, with respect to these investment trusts—I thought investment trusts were absolutely distinguishable from an enterprise which seeks venture money or risk money, where those who are investing are willing to take the chance of building a new airplane or a new something else, and recognize that it is a great risk.

I understood that an investment trust's primary purpose is to accommodate this investor—usually a small investor—who has not enough money to invest in a number of securities, and yet who would like to get the benefit of that. He wants to take his money and put it into the hands of an investment trust which diversifies its investments and picks only investments in securities which have a recognized value upon the market or which are generally recognized as safe investments, as the result of some experience.

Of course, as your testimony has shown, because there is no control over some of these sponsors, the trusts have been used for these new ventures, without the knowledge of those who invested or, really, contrary to the purposes of the trust, as represented to these investors.

Am I mistaken about that?

Mr. SCHENKER. Senator, your idea of an investment trust conforms to the layman's concept of what it is. But the fact of the matter is that our study shows that you have this great diversity of types of investment companies. Perhaps they should not be called investment trusts. So the situation is that although they may have raised their money initially on the basis that the public believed it was the type of institution you believed it was, the fact of the matter is that the history of these institutions in this country shows that they went into the other type of activity.

Senator WAGNER. Well, I do not object to that.

Mr. SCHENKER. This bill takes jurisdiction of all types; and the only thing it says is substantially as follows: "Now you will have to tell the person that you are type A and you will have to stay in activities in which type A may indulge; and before you may indulge in the promotional venture type, you must tell your stockholders that and get their permission."

Senator WAGNER. Of course, I believe in this risk money; but I ought to be told that that is what I am undertaking.

Mr. SCHENKER. That is right.

Senator WAGNER. Under those circumstances I ought to be told that I am not undertaking a substantial, sound investment enterprise

but I am taking a chance on something which may turn out to be a 100-percent loss.

At the present time I think there is need for that kind of money; there is no doubt about that; but I ought to be told just what I am investing my money in.

Mr. SCHENKER. The fact of the matter is that the Commission had the definite feeling that if this legislation were passed, it might encourage people, who felt that this type of institution was under some kind of supervisional regulation, to invest in a venture investment company, you see. We felt that it would serve a salutary economic purpose, in having people taking their savings deposits and putting them in this type of company with the full consciousness that they are taking that type of risk, if all the shenanigans of the past are out and the company has this type of supervision by a Government agency.

That was one of the things that was a great factor with the Commission; that this would encourage the opening up of the capital markets, by making provision for the small person who had some surplus funds—after he had made provision for a bank account and insurance—to take a little speculation in industry and put a little money in that type of organization.

Senator WAGNER. In all of the cases of which you have spoken thus far the representations made to the investor were just to the contrary?

Mr. SCHENKER. In most cases.

Senator WAGNER. I do not know of any case where the investor was told he was putting his money into a venture of some kind. In all these pamphlets you presented here the investor was told he was investing in a diversified investment trust which was a sound investment and which was secure in the future; isn't that true?

Mr. SCHENKER. That is substantially correct, Senator.

Senator WAGNER. Yes. All right.

Mr. HOLLANDS. Mr. Chairman, in connection with the point you were just discussing with Mr. Schenker, I should like to call your attention particularly to paragraph (2) of subsection (b) of this section 21, which reads as follows:

> It shall be unlawful for any registered management investment company to lend money or property to any company, directly or indirectly, if—
>
> (2) The investment and management policies of such registered company, as recited in its registration statements and reports filed under this title, do not specifically authorize such a loan.

The purpose of that, of course, is to make sure that if this company is going to make loans of a venturesome character, it has indicated that it is going to go into that business.

Senator WAGNER. I do not want to be too critical about these things, of course; but do you not simply say that, "If you do something which is contrary to the powers conferred on you, you are doing something contrary to the powers conferred on you?" Is not that about what you say in this provision we are now discussing? It seems to me that it declares unlawful something which is unlawful; is not that the situation?

Mr. HOLLANDS. That is substantially true, sir. It states that unless you have represented and made it clear that you are going to go into this loaning, you cannot do so. You might have power under your charter but have failed to make it clear in your registration statement

that you really intended to engage in this type of business in the immediate future.

Senator WAGNER. I see; I beg your pardon.

Mr. HOLLANDS. Section 21 (c) deals with borrowing by investment companies. There are a number of minor questions that arise there; but the principal question is this: The Commission feels, as I think the testimony yesterday made clear, that an investment company should not be operated substantially as a margin account. An investment company may have no debentures or preferred stock outstanding; it may have only common stock; and yet the same effect of a margin account can be obtained by large bank borrowings. Those bank borrowings will be a fixed charge against the company; and, because of the fixed charge, the value of the common stock will shoot up and down in the same way that it would if they had debentures outstanding.

The problem that we had to meet in this section was to cut down the leverage arrangements of that type and at the same time not embarrass companies that need to borrow in order to get over a brief period of time.

As far as we can see, there should be no need for long-term borrowings by the investment companies—certainly not by the diversified type. They have marketable assets; that is what their entire assets consist of—marketable securities, with relatively few exceptions. But there may be need for short-term loans.

So this section provides that a company may borrow up to 5 percent of its assets, for temporary purposes. Temporary purposes are put at 60 days. Perhaps 30 days would be better; perhaps 90 days would be better; I do not know.

Incidentally, the 60-day provision is only presumptive; if the actual use is a temporary use, even though the loan is extended for more than 60 days—and the company can establish that fact—the loan is not invalidated.

Senator WAGNER. What do you say is the purpose of a loan of that kind?

Mr. HOLLANDS. For instance, they might want to borrow money in connection with dividend payments; in other words, they might have made profits but they may have invested them and they do not want to liquidate at the moment, and they wish to borrow money for the purpose of paying the dividends, and then liquidate a little later when the market is in a better position.

Senator WAGNER. All right.

Mr. SCHENKER. Section 22 deals with the problem which Mr. Bane discussed in detail—that is, the possible dilution of the equity of certificate holders in open-end companies.

Section 22 (a) gives the Commission power to formulate rules and regulations to meet that situation. The only thing I wanted to say about that, Senator, is if the industry has any difficulty with giving the Commission power to formulate rules and regulations, then the Commission is prepared to recommend to the committee a specific provision which in its opinion will meet that situation.

We talked to the industry; we had the feeling that, although our plan to meet that situation is at least theoretically perfect, they say it may have some undesirable consequences in connection with their distribution activities. The suggestion was, then, "Why do you want to get yourself locked into a statute? If the formula does not work,

you will have to go to Congress. Why don't you make it subject to rules and regulations, and we can experiment with that."

That is the reason for the rules and regulations provision.

The purpose of subsection (b) is to take care of what we call "riskless trading," where the dealer or "insiders" or people who are "in the know" can take a position against the trust. If I may, for a moment, I shall just explain that.

Remember that we said that in these open-end companies they sell on Tuesday, based on Monday's prices. The dealer can go and confirm orders on the basis of Monday's prices. If the market goes down on Tuesday, he can say to the trust, "You sell me the shares on the basis of Tuesday's prices."

Then he takes the shares that he bought on the basis of Tuesday's prices and delivers them to the customer to whom he sold the shares, on the basis of Monday's prices, which were higher.

Senator WAGNER. That is a dilution process?

Mr. SCHENKER. That is a dilution process, coupled with what we call a riskless trading process. It is a sure thing; you cannot go wrong; because in effect he has a call for the stock of the investment trust at a fixed price, and if the market goes down he exercises the call, and if it goes up he says, "Give it to me at today's price."

That is a complicated problem, and we are not making the charge that it was done helter-skelter. We have found cases of it; it is possible to do it. But unless the problem presented by this situation is met, an injustice may be done to the certificate holders. That is reason for the provision in subsection (b) of section 22.

The (c) provision deals with this type of situation: we have used examples where the sales load ranged anywhere from 5 to 20 percent of the price of the security. They compute the price of the certificate and then on top of that they pile the sales load which is to reimburse the distributor for his effort in distributing the security and, of course, to give him his profit. You can see what that means, Senator. That means that if you have a very high load the performance of that investment trust will have to be so good that it would have to overcome the sales load which the public is paying.

If you get a very high rate of load, then the investor can never win, because the performance of the management may never be of the caliber to earn enough money to compensate the certificate purchaser for the price he paid for the privilege of having the management manage his money.

Senator WAGNER. In other words, may I put it simply in this way—or am I wrong? In the case where the load rate is 9—they are as high as 9 percent, are they not?

Mr. SCHENKER. They are as high as 20 percent in some cases, or 17 percent.

Senator WAGNER. How much must my investment earn on top of that load, before I can get any dividends?

Mr. SCHENKER. Before you can even talk about a dividend I am trying to figure out what the management must do before you will even get your money back.

For instance, with a load of 20 percent, which today is not unusual, that means that the market value of the money you invested and which went into the trust after the sales load was deducted would have to rise at least one-fifth, before you are even. Isn't that so?

In other words, suppose the price of the certificate is $100 and they put a 20 percent load on it: That is $120 that you pay, but only $100 of your money is invested. Under those circumstances the management has got to make $20 on $100 before you are even. Isn't that so?

Senator WAGNER. Exactly.

Mr. SCHENKER. That is the situation.

Senator WAGNER. So that difference has to be over 20 percent before you get anything, does it not?

Mr. SCHENKER. That is right.

Now, Senator, we did not assume to recommend to the committee that a fixed maximum load be incorporated in the statute—at least, not in this type of company. We did fix a maximum in the installment plans.

Now, Senator, why do we not do that? Well, you can see what happens. Today some of these companies sell with the load at 5 percent or 6 percent. If we fix it at 9 percent—and some people say they need a 9 percent load at some times, to be able to sell them—immediately the maximum would become the minimum in every case. They would say, "The S. E. C. in its recommendation to Congress said that 9 percent is all right"; and then everybody would charge 9 percent.

We think that for the present, at least, we ought to leave that to competition among the different distributors. We do say this—and we say it because we do not want to see our face get red at the same time: Suppose a fellow comes in and says, "I want to charge a 40 percent load", and he makes the disclosure. Then we have no power to say, "You cannot charge 40 percent." Although he discloses it and the person still buys it, it is clear that he did not understand it and therefore, it necessarily is inherently a fraud.

Therefore, we have made the recommendation and we have used this strong language because we do not want the industry to feel uneasy because of any belief that once this legislation is passed, if it is passed, we are going to require a low load.

So we say that if it is an unconscionable or grossly excessive load, then the Commission can institute a proceeding to have them stop selling the securities. That would give them an opportunity to be heard, and we tried to set forth standards with respect to what the Commission should consider in determining whether the load is excessive. For example, we state on page 50 that you shall give weight to the denominations of the certificates. If you sell a $10 certificate, perhaps there should be a different consideration than if you are selling a $100 certificate. We also state that due weight shall be given to the incidents, the selling price, the kind of organization, the investment policy, the past and prospective earnings, the management expenses, management and sales methods of the issuer, the distribution cost, and so forth.

So, Senator, with respect to the sales load, the Commission has not recommended any specific amount; but if the industry wants a specific recommendation instead of this rule-making power, I think the Commission would be prepared to tell the committee what they think the maximum load ought to be.

However, we felt that this is a technical problem. Since they sell continuously, there may be conditions where they ought to have a little more sales load or a little less sales load. We are prepared to

recommend to the committee that it be left to competition, in the first instance.

The next provision states:

The Commission is authorized, by rules and regulations or order in the public interest or for the protection of investors, to prohibit—

(1) The suspension, in whole or in part, of the redemption privileges of any redeemable security of which any registered investment company is the issuer.

They sell these securities to the investor on the sales talk: "if you are dissatisfied with the management, you can come and get the value of your certificate at any time you are displeased."

However, you will find the situation where the management has the power to suspend that right of redemption. Thus, although the fellow in the first instance bought it in reliance upon the fact that he could come to the company and tender his certificate and get the value of the certificate upon request, there is buried somewhere in the trust indenture a provision saying that the management under certain circumstances can either suspend it for a short period or, in some instances, for a comparatively long period. We have made an analysis of all the trust indentures.

We are not prepared to say to this committee that you ought to prohibit the suspension. You never can tell whether an emergency may arise. Suppose war is declared, with the result that the stock market "fell out of bed" and you had a tremendous "run." Then it might be a matter of the industry's saying, "Take your time; for the next week you cannot redeem your certificates."

That is different from a case where there is an ulterior motive, where a man is getting a lot of redemptions and his management fees are being cut into, and he says, "From now on nobody can redeem."

We pointed that out in the report, and it sounded very theoretical and hypothetical; but, sure enough, several weeks after we handed in our report, two open-end companies suddenly completely suspended redemption. They may have gotten the permission of the stockholders, but you know what control of the proxy machinery is.

We get a letter, such as this letter addressed to the chairman [reading]:

Re Maryland Fund.

Sometime ago the above-named church made a substantial investment of endowment bonds in the Maryland Fund, Inc. At the time said investment was made we understood that our stock was redeemable at any time at its liquidating value. We have now been informed by our broker that the directors of the said Maryland Fund have recently declared this provision to be no longer in effect.

We are also informed that the liquidation value as of today is $5.27 and that the best obtainable bid for the shares is $4.

From the portfolio of securities held as per the last statement of the Fund, we see no justification of the action as above reported to us. Your opinion and suggestions as to this matter will be greatly appreciated. As the shares owned by our church cost us approximately $9 per share, bought at the market, we stand to suffer quite a loss on our $10,000 invested—

Their investment today is worth $4,000; they paid $9,000 for it—

Thanking you for your consideration, I am,

Very truly yours,

——— ———,

Treasurer of the Trustees of the Union Methodist Episcopal Church of St. Louis, Mo.

Now, Senator, this is not an unusual letter; we have received these by the hundreds. We have our file here. We are absolutely helpless, and we say that some provision ought to be made in that situation.

Senator Wagner. You say the trust indenture had a provision. Was there a limit on the period during which the suspension of redemption could continue?

Mr. Schenker. As I remember it, there was a limit; but it did not give them the right to do it specifically. We have written for all the information from the company. They may or may not have been required under their trust indenture to get the certificate holders' consent.

However, even if that provision is there, you know what can happen. It all depends on what explanation you give these people when you ask them to give you the right to suspend. That is a rather important problem, and we feel that it ought to be a subject of rules and regulations to prevent a recurrence of this type of thing.

Senator Herring. They retain the right to revise the conditions between themselves and the stockholders?

Mr. Schenker. In most trust indentures, Senator, and in practically all of these open-end companies, there is some provision for the suspension of this right; and the rationale for that provision is, "Well, we have got to meet emergencies."

However, some of the provisions permitted suspensions for a very substantial period.

What was happening in this case, I suspect, was that the certificate holders of the Maryland Fund were being switched out into other open-end companies. You see, it is an easy matter to switch somebody out into another open-end company; the investor can get his money or the dealer will do it for him, and then the dealer says, "Why do you want to bother with this Maryland Fund? We can give you our certificate, and this other one is much better."

Of course, I say that is merely a theory of what may be the fact.

I did get a letter from another company, sometime back, stating that the management of this company had some difficulties with the whole concept of an open-end company. The writer felt that here you had a big fund which was always subject to demand liabilities. He felt that was a big headache. I understand that he has asked for an opportunity to come before the committee. He probably will elaborate on the difficulties of the open-end company and why he did this.

Now coming to subparagraph (2) of (d), it just says that the Commission shall have the right to make rules and regulations with respect to any restrictions upon the transferability or negotiability of any redeemable security of which any registered investment company is the issuer.

There are some companies that have a provision in their certificates to the effect that you cannot sell that certificate to anybody else, and the only way you can sell it is to sell it back to the company. That is a technical problem. It presents a whole problem which they call the bootleg market. What happens is that dealers keep switching people from one company to another. In order to prevent these switches, some provisions require that you cannot make these switches but must sell the certificate back to the company. That is a big problem; but it seems to me they are taking away a very valuable indicium of the ability of the company, and it seems to me you are taking away a big portion of the owner's right of initiative.

If the committee wants the provision, we shall recommend what, on the basis of our experience up to the present time, it ought to be; but we think subjects like that ought to be a matter of rules and regulations.

Senator WAGNER. You provide rules?

Mr. SCHENKER. That is right.

Senator WAGNER. You provide rules, I suppose, under which they make application to the Commission with respect to whether they may or not?

Mr. SCHENKER. No. If this bill becomes law, and after we study the whole situation, if we feel there are abuses which cannot be corrected except by putting in a restriction on alienability, then we shall formulate rules, after discussing them with the industry.

Senator WAGNER. I mean to say that those who desire to suspend redemption would have to come, I take it, to the Commission and give their reasons; and then there may be a modification?

Mr. SCHENKER. Well, we can deal with that in two manners, under that section.

Senator WAGNER. How else can you do it?

Mr. SCHENKER. We can do it by rules and regulations which would be applicable to everybody or we can do it by order, which would be by application by a particular company.

Senator WAGNER. But if you do it by rule, you have got to provide some standard under which this provision may be suspended?

Mr. SCHENKER. That is right.

Senator WAGNER. That is difficult, is it not?

Mr. SCHENKER. Well, that is why we say that is a matter for rules and regulations.

Senator WAGNER. All right.

Mr. SCHENKER. We would sit down and talk to the industry and get their ideas and their reactions; and you could work it out.

Senator WAGNER. I see.

Mr. SCHENKER. But once you put it in the statute, and if it thereafter does not work out, then you are in trouble, unless you have a broad exemptive power, that we provided in the first instance. Remember that we say we can exempt any particular transaction from the purview of the regulation.

Now we go on to the distribution and repurchase of securities.

Section 23 (a) in substance says that no registered closed-end company, as contra-distinguished from an open-end company, shall sell the securities of the company in violation of such rules and regulations, at a price below their asset value.

What we say is that a company shall not sell its present stockholder's dollar to anyone else for less. However, we are not unmindful of the fact that there may be situations where it may be to the interest of the corporation, and not to the substantial detriment of the stockholders, that the company be permitted to do so.

You take the situation where they have observed the stockholders' preemptive right and have offered the securities to them, and they cannot raise the capital. Then under those circumstances possibly the company ought to be able to sell its securities to other people at less than the asset value. There are a number of situations like that.

We feel that is such a technical problem as to be a matter properly subject to rules and regulations.

However, now it is not subject to rules and regulations and you have the instances where you can see that the controlling company stock can be sold at blank dollars and at blank dollars—so many less, you see.

Now, we come to (b), and that is the matter I discussed with Senator Taft, who manifested the feeling that no investment company should have the right to buy back its stock at all.

That is true in England and in Australia. However, it is not an easy problem. In the first place, in the case of the open-end companies—and I think it just slipped the Senator's mind—the whole theory of the open-end companies is that the company may be able to buy back its stock.

But in the closed-end companies, if the investors were going to sell that type in market, they might take a substantial loss; and perhaps in that case the company should have the right to buy back its stock. However, we say we want to make sure the legislation will protect everybody and not just the insiders, to be able to sell back their stock to the company. If the size of the company is to be reduced, then everybody ought to have an opportunity to reduce his interest in the company proportionately.

That is subsection (b) of section 23.

Mr. L. M. C. Smith. May I just say there, for the purpose of the record, that over five hundred million dollars' worth of securities were repurchased by investment companies; and each one of those repurchases raises the question in my mind as to the fairness of the price that was paid—because the great majority of the securities repurchased were repurchased at prices which were below the actual market value of the securities. That is true of the situation over a period from 1927 to 1935. So it is a major problem.

Mr. Schenker. Mr. Hollands will discuss section 24.

Senator Wagner (chairman of the subcommittee). I am going to ask Senator Hughes if he will not preside. I have an important bill coming up on the floor of the Senate this morning, and I must be over there to take care of it. I think that will be disposed of by this afternoon. I am sorry to have to miss this much; I have not missed a moment as yet.

Senator Hughes. Yes; you have been very faithful.

(Senator Wagner, chairman of the subcommittee, then left the committee table.)

Senator Hughes (presiding). Proceed, please.

Mr. Hollands. On the general problem of distribution of investment company securities, there can be several approaches. Regulatory statutes very commonly require the administrative body virtually to approve the securities in some way or other. Except in the case of reorganizations and exchange offers, we have in general taken a different approach in this bill. There are certain specific provisions such as the provisions regarding dilution and others that Mr. Schenker referred to, that deal with specific problems. Except where those specific problems are dealt with, it was felt that disclosure was adequate; and, of course, the disclosure statute administered by the Commission, in the case of distribution of securities, is the Securities Act of 1933.

Section 24 fits into the Securities Act of 1933 and is designed to give certain additional disclosure in certain particular circumstances.

The provisions are fairly technical; and I shall try to go through them rapidly and just give the gist of what they provide.

Subsection (a) says that in connection with a public offering by the issuer or a principal underwriter of an investment company there shall be registration under the Securities Act of 1933. In most cases registration is already necessary; but there are a few peculiar exemptive provisions in the Securities Act, that make sense as applied to most companies, but not as applied to registered investment companies, that this subsection (a) eliminates.

Subsection (b) is to eliminate any duplication of filings under this bill and under the Securities Act. You will recollect that back in section 8, which provided for the registration of investment companies under this bill, there was a provision that if the company already had filed a registration statement under the Securities Act of 1933 or the Securities Exchange Act of 1934, it could file a copy of the statement for its registration statement under this bill—with, of course, the addition of a current report bringing the material up to date.

Section 24 (b) is the converse of that provision of section 8. This enables the company, when it wants to distribute securities and register under the Securities Act, to employ the registration statement that it filed under section 8, and file a copy of that and file also a current report and the prospectus bringing the data up to date. In that way I think any duplication of filings is eliminated just about as far as it is possible to do so.

Subsections (c) and (d) deal with a slightly different problem. In effect they are designed to strengthen the Commission's powers under the Securities Act, regarding prospectuses of certain types of investment companies. Neither subsection (c) nor subsection (d) applies to closed-end investment companies. With relatively few exceptions they sell their securities in a lump. They have offerings when they need new money, and sell their securities, and then sit tight until they need some more new money. The distribution is commonly through dealers, in much the same way that industrial securities are distributed. So they are not dealt with in this provision.

However, the other types of investment companies are, almost all of them, engaged in continuous sales activities. They have large sales forces run either by the company or by an independent distributor. Occasionally they work through dealers; but that is perhaps the exception as much as it is the rule. There is a good deal of variation there.

The important feature is that there is continuous distribution of the securities and continuous use of sales literature. Mr. Boland described, the other day, some of the misrepresentations that have been not too uncommon in the sales of these securties. Any misrepresentation of that character or any fraud in the prospectus filed under the Securities Act of 1933 would have to be taken out, or the Commission would institute stop-order proceedings. However, the Commission's power in that connection extends only to the formal prospectus, as you may call it, filed under the Securities Act. It does not extend to other literature given along with the prospectus or used as follow-up literature.

There have been a number of instances where companies, after considerable discussion with the staff of the Commission, have finally agreed that certain provisions of the prospectus were misleading and

should be taken out; and then the registration statement became effective; and then, promptly, those same representations were put in the follow-up literature.

Subsection (c) requires that any sales literature which is to be used by the company be filed with the Commission as part of the registration statement; or if they decide to use it after the statement becomes effective, then it must be filed with the Commission as an amendment of the registration statement. That means that it is subject to the Commission's stop-order procedure.

This subsection does not attempt to specify what goes into the literature, but merely requires that what goes in it be truthful and not misleading.

Subsection (d) specifies that a prospectus may be required to contain summaries of information and that the information may be required to be presented in a certain order. There has been some suspicion, although no one can prove it, that the very complicated set-ups of these plans have been emphasized, rather than underemphasized, in order to make their presentation that much less intelligible to the investor, giving that much more weight to the oral representations of the salesmen.

You will recall that it took quite a little while for Mr. Bane, and later for Mr. Boland, to explain even to this committee the complicated pricing arrangements and the complicated set-ups of these companies. The investor is in a difficult position in these cases.

Section 25 deals with plans of reorganization and offers of exchange. May I call your attention first to subsection (d), on pages 55 to 56, which gives the grounds for the Commission's disapproval of a plan of reorganization or offer of exchange, if it decides to disapprove.

The grounds are that the plan or offer is not fair and equitable to all persons affected, and in the case of a plan of reorganization, that the plan is not feasible.

Those are very general words and they sound very loose, but they have, in fact, as I presume you know, a long judicial history. Those are the words that have been commonly used in equity receiverships, in reorganizations under section 77B of the Bankruptcy Act, and opinions as to their meaning are still being ground out under chapter X of the amended Bankruptcy Act.

Senator HERRING. Here you prohibit any person submitting to any court of the United States to approve such a plan. You are taking authority away from the courts to determine these matters, are you not?

Mr. HOLLANDS. No, Senator; we are not. What we are doing is saying that before the court passes on it, the Commission should pass on it. It is the same problem, really, that you have in railroad reorganizations.

In that connection may I say that we had a little discussion about paragraph (4) of subsection (a), and have decided that the phrasing, if I may put it that way, is a little unhappy. There are statutory precedents for saying that a court shall not pass on a plan of reorganization until the administrative body that specializes in that field has had an opportunity to pass on it; but the phraseology there is unhappy, and I am not entirely sure that paragraph (4) is necessary. Perhaps paragraph (3) is adequate.

Essentially, if you are going to have an administrative body pass on these plans, Senator, it is questionable whether the procedure should be an immediate recourse to the district court. The facts are all developed before the Commission. As a matter of fact, the issues of fact are much less in these cases than issues of law or issues of fairness.

Senator HERRING. I think that so far as administration and regulation are concerned, I am well content to leave those things to the courts yet. I think we are going too far altogether with semijudicial boards and commissions. I prefer to have them go to the courts. Let us take a chance on the courts yet awhile.

Mr. HOLLANDS. I think, Senator Herring, a distinction could be made there between cases where the reorganization is in court and cases where it is accomplished outside of court, by what are known as voluntary adjustments.

Senator HERRING. There is not much voluntariness about this, when you say they may not.

Mr. HOLLANDS. I mean a voluntary adjustment by the company itself, as distinguished from a receivership where the company is forced into court to work out a reorganization. I am quite sure that we have no fixed feeling on what the exact mechanics should be here, except that the investor is extremely helpless in these situations, and some power must be given to the Commission.

Mr. HEALY. I suppose it grows somewhat out of some experiences that we have already had under the Holding Company Act in connection with reorganizations of companies in holding company systems, which have to be strained through the S. E. C. before they get to the court. Our decision does not bind the court; that is, we may say a thing is all right and the court may say it is all wrong; but we have to take a look at it. You have a similar procedure in the Interstate Commerce Commission in respect to railroad reorganizations, and I am not sure but you have the same thing in communications, with respect to reorganizations of companies engaged in communications.

The work that has been done under chapter X of the Revised Bankruptcy Act, the Chandler Act, where we write advisory opinions for the courts on reorganization plans has brought from the courts a great many expressions of gratitude. That is, the courts are very busy and very pressed and they are not specialists in the field of reorganization law. I could produce a number of letters, if you cared to see them, from judges saying that they appreciate that kind of assistance very much. We have even had such a letter from one man who was very much opposed to the idea in the beginning, but who now feels very definitely that it relieves him of a great deal of work, and is very useful to him.

Senator HERRING. I am not as much concerned about the judges as I am about the investors and the individuals. What is the use of their going to court?

Mr. HEALY. I think the experiences in reorganizations, if you will permit me to say so, are somewhat in the other direction; that is, the court not being a specialist in that field, and being very much pressed with too much work, permit a good many reorganizations that are completely unfair to the stockholders, and especially the unorganized, scattered security holders, to get through the court; and I do not think they would get through the S. E. C.

I think it could be demonstrated that, on the whole, this power of the Commission, an administrative body that more or less specializes in this field, to see that the investor gets justice, more than offsets any delay. As a matter of fact, in the recent Utility Power & Light reorganization, Judge Holley out in Chicago appointed a special master who sat with our trial examiner, and it shortened the whole process.

It is my contention that instead of our participation resulting in delays, I think it shortened the whole process.

I do not feel too strongly about this, and of course it is entirely in the hands of the committee. If you see fit to take away from us completely the power of making a finding as to whether a plan is fair and equitable, and so on, then I suggest that perhaps you would be willing to allow us to write an advisory report which would be submitted to the court and the security holders. We think that an impartial body which has no money stake whatever in the result can step in and analyze one of these difficult situations and be quite helpful. In a great many cases the security holder does not know whom to believe. He gets all sorts of conflicting statements as to what the plan is and what it means, and so on. We will make mistakes, of course, in some of our analyses, but on the average our analysis would be much more reliable and understandable than that presented by somebody who has a money stake in it. I am not sure that the work which the Commission is doing under the Chandler Act is not the most useful of its functions right now.

Senator HERRING. Under that act, of course, you merely recommend. Under this you prohibit.

Mr. HEALY. That is true.

Senator HERRING. There is quite a difference.

Mr. HEALY. Yes.

Mr. SCHENKER. May I say one word there, Senator?

Senator HERRING. Certainly.

Mr. SCHENKER. The type of situation you are talking about and that Judge Healy was discussing is the type of situation where a petition under 77B of the Bankruptcy Act is filed in court. Under those circumstances the Chandler Act says that the Commission should study the situation and file an advisory report with the court. However, the situation with which this section deals is where there is no petition under 77B filed.

I am not being critical in this. You take the whole plan of the merger between Curtiss Wright Corporation and the Atlas Corporation, that is, the exchange offer. The fact of the matter is that the Atlas Corporation, through exchange offers, without a court to pass on the exchange offers in a single one of the instances, absorbed 21 investment trusts by this voluntary reorganization procedure, rather than by involuntary reorganization where petition would be filed under section 77B and a court would supervise it.

Also The Equity Corporation absorbed many investment trusts. No court had any supervision over the exchange offers. That was an entirely voluntary situation.

We have hundreds of letters admitting that there ought to be some independent agency to examine these offers to see whether they are not an imposition upon the investor.

These voluntary exchange offers where corporation A makes an offer to exchange its securities for the securities of another investment

company, do not pass before any court, Senator. Today nobody has any jurisdiction to look at such exchange offers, to approve it, or even to write an advisory report in connection with it.

Senator HERRING. I am not complaining of the effect you are aiming at. The question is only about the method. That is the point.

Mr. SCHENKER. Then your suggestion is, Senator, or your present reaction is, at least, in this type of situation, to say: "Why do you not use the same type of procedure used in 77B and send out an advisory opinion to stockholders suggesting that the exchange offer is fair or unfair, and let them make up their own minds?"

That is one approach to it. I will not assume to speak for Judge Healy, but I have the feeling that possibly he feels that may be sufficient.

However, I conducted the examinations on the Equity Corporation and the Atlas Corporation, and I found this situation. Usually the persons who are interested in effecting the exchange offer have sufficient voting power to push it over, and therefore that leaves the minority stockholder in this position: Unless he is conscious of his legal rights, without his consent and without his volition he can be made a stockholder in another investment company. It is that group of people who are not even remotely conscious of what their legal rights are under the circumstances, and because of the small size of their holdings cannot afford to go out and get lawyers or investment counsel to apprise them of their rights who are virtually powerless. You may tell them it is unfair, and they may agree that it is unfair, but there is nothing they can do about it, because the people who are interested—and they may have some ulterior motive and they may not—in seeing that the exchange offer is effected, usually control the offer.

We have set forth in a 600-page report the devices they use. They pay commissions to the officers and directors of the companies of which they want to get control, to write letters to the stockholders. You can see the situation. The S. E. C. will say it is unfair, but they get people upon whom the investor has some reliance, and he says just don't pay any attention to that.

Mr. HEALEY. I wonder if it would go any distance toward meeting your point, Senator, if this were rewritten, so that when the reorganization is before the court, we might write only an advisory report and not have the power to approve or disapprove.

Senator HERRING. Yes.

Mr. HEALY. But where the reorganization or exchange is being put through out of court, and there is not any governmental body with authority in the matter, in that kind of a situation the power of the commission might be more than merely to advise but to approve or disapprove, pursuant, of course, to a rule of law laid down in the statute.

Senator HERRING. Because, if we have any chance of passing legislation of this kind, we have got to do everything we can to allay fear and misapprehension. That is why I brought the question up.

May I ask, Senator Hughes, if you are going to meet this afternoon?

Senator HUGHES (presiding). We will try to meet again at half past 2.

Senator HERRING. I would like to go over to the floor of the Senate. There are some things coming up over there in which I am very much interested.

Mr. HEALY. I would like to further consider what you have said, Senator, and perhaps we can discuss it further.

Senator HERRING. Yes.

(Senator Herring withdrew from the committee room.)

Senator HUGHES (presiding). I think we might go on until 1 o'clock, and then take a recess until half past 2 this afternoon.

Mr. HOLLANDS. I will go right on with section 26, Senator, because if there is to be any further discussion of section 25 I think Senator Herring would like to be present.

Senator HUGHES. All right.

Mr. HOLLANDS. Section 26 deals with what are called unit investment trusts in this bill. They are commonly known in this country as fixed trusts, and in some cases as semifixed trusts.

You will recall that Mr. Schenker told you the other day what developed in connection with those trusts. They came into life and were most active particularly after the stock-market crash, when there was not too much faith in the management type of trust. They are not a very large factor today, although there are still some of them, and they may start up again later.

There are two principal problems which I will mention in this connection, without taking up all the provisions in detail.

The first problem is to prevent a trust's becoming what is called an orphan trust. This may happen when a sponsor actively sells securities of the trust and finds that he cannot sell any more and so virtually goes out of business, or organizes another and ties up with another trust in some way. The trustee of course could still carry it on, but sometimes no provision is made to remunerate the trustee, and since he has no possibility of remuneration out of the funds of the trust, he just sticks the stuff in a safe-deposit vault and lets it sit there.

There are several provisions in here to make sure that the trust will not become an orphan, and that the depositor will not sell his depositorship, which is a problem similar to that of a manager selling a managing contract. In addition there is a provision that when a trust has become an orphan and no one has taken steps to liquidate it, the Commission may file a complaint in the district court and seek to have it liquidated. The Commission, in effect, would be an amicus curiae in that case to see that there is a dissolution.

Senator HUGHES. Is there any place in the bill—if there is, I do not recall seeing it—where there is a definition of a unit investment trust?

Mr. HOLLANDS. Yes, sir; in paragraph (2) of section 4 on page 9.

Senator HUGHES. Proceed.

Mr. HOLLANDS. The essential distinction between these trusts and the management trusts is that these trusts have virtually no management. The investor really exercises his own judgment, because he is ordinarily shown the list of securities in which his funds will be invested, and it is only under very special circumstances that the portfolio can be changed and those securities eliminated and others substituted.

I may say that I think it is obvious that many of the earlier provisions we have been discussing simply did not apply to those com-

panies. Those provisions have been made applicable to management investment companies and in most instances have been expressed as being applicable only to management investment companies.

Mr. SCHENKER. Section 27 of the bill deals with installment investment plans. These plans are devices whereby they sell an investment trust on the installment plan. The section provides, first, that the sales load shall not be more than 9 percent. Provision is then made to insure that this 9-percent load is not taken out of the first few payments but is equitably distributed over the life of the contract, so that if a person defaults or surrenders his certificate in the early stages of his contract, he will not lose all his money.

We also have the provision that the payments should not be less than $10 a month, and that the first two payments should be $20 each. That is in conformity with the suggestion of the industry that such a provision be incorporated.

The reason for requiring a $20 payment for the first two payments is that you will at least not sell a certificate to a fellow who has not got $20 for the first payment and $20 for the second payment. They tell me that sometimes $5 will make a difference between a sale or no sale. If a fellow had to put up $15 instead of $10 they could not make the sale. That is how short a margin the prospective investors have. And this will have the effect of cutting out sales to miners, policemen, nursemaids, and servant girls, and get to the professional people, the small-business men, who can afford to do it.

The next provision says that the certificate holder shall have the right to his value of the securities; and paragraph (2) says that the securities and the proceeds of the sale must be in the custody of a trust company or a bank.

Subsection (c) has a provision to insure that there will be a trustee in the picture and that he cannot resign unless a substitute trustee is provided for.

Section 28 deals with face-amount certificate companies. Those are the companies that Commissioner Mathews spoke about, which sell unsecured promissory notes on the installment plan. With respect to that type of company we say they cannot start doing business unless they have $250,000 of assets, which is the figure usually provided for insurance companies by State laws.

Then we make provision for these types of situations: We provide that those who want to get out of the plan do not take too substantial a loss in the early years of the contract. We make provision requiring the companies to create reserves which will insure that they can fulfill their contracts if the investors keep making the payments until maturity. And then, in order to get away from that type of company which has automobile paper, or may have commodities, we say that the type of investment the companies should make, at least with respect to their reserves, should be the type of investments made by life-insurance companies.

We also make provision that the reserves can be required to be deposited with a trustee.

Paragraph (d) is the provision relating to surrender value:

Paragraph (e) says that the person who buys one of these certificates on the installment plan shall not be liable for the unpaid balance. If he makes 10 payments and wants to quit, then he is not liable for the balance of the payments. That is the situation at the present time.

Senator HUGHES. If he wants to quit, he can withdraw what he has paid in?

Mr. SCHENKER. That is right; and they cannot sue him for the balance.

Paragraph (f) deals with this situation: Suppose you buy one of these certificates on the installment plan and make regular monthly payments for 9 years and then you default on one $10 payment. They stop the running of interest on all the money you have paid in. So this provision is to eliminate that sort of thing, and to make some equitable provision that he gets interest on the amount that he has already paid in.

Section 29 deals with this situation: Some of the States today require that the company deposit with the securities commissioner securities or assets sufficient to cover the surrender value of the certificates sold in that particular State. There is some question whether that type of provision is effective in order to accomplish the purpose which is sought to be accomplished—namely, to protect the certificate holders in that particular State. You get this problem, however. One State requires more than is necessary. Some States do not require enough. There is a great diversity of amounts of deposits. What would happen if the company should go into bankruptcy? Then you would have the situations first, are these deposits sufficient to give the certificate holder a preference with respect to these particular assets? Secondly, you would meet the problem that because of some fortuitous circumstance, or because one security commissioner was more alert than another, the security holder who happens to live in one State will get all his money, and the security holder who lives in another State will not get his money.

We do not disturb the present deposits and the situation with respect to future payments made on outstanding contracts. We do say that with respect to future contracts, if the company goes into bankruptcy, then any deposits which have been required by the State security commissioner for those future sales should have no effect, and all the certificate holders, regardless of what State they live in, should share equally in the assets.

Senator HUGHES. Do they have laws of that kind in some of the States dealing with investment companies?

Mr. SCHENKER. Only with this type of company, Senator. This is the company that sells unsecured promissory notes on the installment plan.

Mr. HOLLANDS. Section 30, Senator Hughes, contains what are substantially the usual requirements in statutes which the Commission is now administering, for annual and other periodic reports and certain special reports to keep up to date the information that is filed in the basic registration statement.

I might point out specifically that subsection (b) of section 30 requires the Commission to integrate the reporting under this bill and under the Securities Exchange Act of 1934, so that the companies can file one copy and one report and satisfy both acts.

Subsection (c) is a very important provision. There is no provision to that precise effect in the Commission's existing statutes. It says, in effect, that the Commission can require registered companies to send reports to their shareholders which shall contain such of the information contained in the company's reports to the Commission

as the Commission specifies. The report can also contain other information. The section sets a minimum there, but it does not set a maximum.

The purpose of the provision is to make it possible for the Commission to make all investment companies conform to the present practices of the more reputable companies.

Senator HUGHES. I suppose when we hear the opposition to the bill, one principal point will be the difficulty of making these statements and the cost and expense of them, and all that kind of thing. It always is.

Mr. HOLLANDS. A great majority of companies already send reports to stockholders. I do not think that there would be much difficulty in tying those reports into the reports they file with the Commission.

Senator HUGHES. I suspect the information is meager, like most of the reports that companies send to their stockholders.

Mr. HEALY. I think it may be said that the real source of this particular provision in the bill grows out of experiences we have had under the Securities Act, where we analyzed a number of the annual reports that the corporations were sending to their stockholders, and found that there were variations and inconsistencies between the reports filed under oath, under the Securities Act, and those which were sent to the stockholders with the annual report. What we are trying to get at here is to really get rid of that kind of thing. I do not think the industry will find any fault with that general principle, although they may find fault, and perhaps with some justice, with the provision that we might ask that the reports be made too often, or something of that sort.

Mr. SCHENKER. In that connection, Senator, that is the value of the provision which gives the Commission the power to classify companies. We can say a small company shall only send out reports semiannually; that a big company shall send them quarterly. Also it indicates the value of the exempting provisions. We can say that a small company shall not be subject to these rules.

Mr. HOLLANDS. Subsection (d) makes the beneficial holders of more than 10 percent of the outstanding securities of investment companies, and the officers and directors of such companies, subject to what are substantially the reporting requirements and the liability provision of section 16 of the Securities Exchange Act of 1934.

In other words, the purpose of this subjection is to make all registered investment companies subject to the same provisions regarding trading by insiders in the company's securities that the listed companies are now subject to.

I may say in that connection that the drafting of subsection (d) is defective and needs a lot of patching.

Subsection (e) deals with another problem that is peculiar to investment companies. You may have a case of officers, directors, or other insiders trading to their own advantage and to the detriment of the trust, not in the securities which the trust itself issues, but in portfolio securities of the trust.

That is not a matter that is probably of terrifically frequent occurrence, although it can be very bad when it does happen. It is also a very delicate matter to deal with. We are attempting here to reach a compromise between the various considerations by making this provision. The insider is required to report to the board of

directors of the company—and this applies only to management companies in any case—all purchases and sales which he has made during the past fiscal quarter, of securities held in the portfolio of the company; that is, securities of the same issuers. The report does not have to be made until 30 days after the end of the quarter. It is made only quarterly and is made only to the board of directors of the company, not to the Commission, to insure privacy. The practical effect of that should be that there would be no serious abuses in trading against the trust, because the person has got to disclose it to the directors.

Mr. Schenker. On that aspect, Senator, we have a great many instances where officers and directors will trade in the securities or buy securities a little before the investment trust does, so that the insider is getting a free ride on the purchases of the stock by the investment trust.

You see, the whole business of the investment trust is trading in securities. You may meet a situation where there may be conflicts of interest between the officer buying the stock and the investment trust buying the stock. The officer may buy his first and get the stock at a cheaper price than the investment trust does.

We say in that situation that he ought to tell his board of directors that "I was trading in or buying securities which you have in our portfolio." He does not tell it to the Commission. He tells it to his own board of directors.

The fact of the matter is that this is not a novel provision. There are several investment trusts which—after we started our investigation—voluntarily adopted that provision, and went further than we did, and said that at the time the investment trust was trading in the securities no officer, manager, or employee should trade in such securities. So it is really a requirement of a practice which has been adopted by some investment companies already.

Mr. Healy. Section 31 of the bill deals with accounts and records; and I think enough has been said to make it plain that the matter of accounts and accounting of these companies is an extremely important matter and lies close to the heart of a great many of the difficulties.

This section requires the keeping of accounts which are made subject to the Commission's inspection at any time. The purpose is to make these companies subject to the same type of examination as are national banks, although it is hoped that such extensive and regular examination will not be necessary in actual administration.

That, in general, is the import of sections (a), (b), and (c).

Paragraph (d) authorizes the Commission to prescribe uniform accounting rules; and this power extends not only to uniform methods of keeping accounts, but also to uniform methods of determining what entries should be made, and in what amount.

I would like to say that if this authority is given the Commission, it will be worked out exactly as the same authority was worked out under the Holding Company Act when we got up our uniform classification of accounts for holding companies and servicing companies. That was done in consultation with the industries and with the leaders of the accounting profession.

The lack of uniform standards and the lack of dependable standards in the accounting field has had very bad effects in many directions, and nowhere any worse than in the investment trust field.

Section (e) permits the enforcement of the uniform accounting rules by requiring by order that the company may make specific entries in specific books. Otherwise the only remedy would be the institution of punitive or injunctive proceedings for violation of the uniform accounting rules.

Section (f) is a technical qualification of the paragraphs that I have described. It permits the companies to maintain supplementary records, provided they do not impair the integrity of the accounts classified.

Section 32 is somewhat along the same line and deals with accountants and auditors. I will describe it very briefly and in very general terms.

Subdivision (a) requires that except in emergencies any independent public accountant retained by an investment company shall be selected by the company's stockholders.

I think that the benefits that may come from that are largely psychological, but it will help to bring home to the independent public accountant that he is not any longer retained merely to find out if somebody in the office force is stealing the petty cash or merely to inform the directors as to what has happened in their company, but that under the existing statutes and existing practice that independent public accountant is really acting for the security holders rather than for the management.

Senator HUGHES. The security holders have selected him?

Mr. HEALY. If this bill is passed the stockholders are to select the independent accountant.

Senator HUGHES. I thought I saw something in the bill about the voting securities.

Mr. HEALY. That is true. I did not realize you were making a distinction between voting securities and other securities.

Senator HUGHES. I wondered whether other securities had an interest.

Mr. HEALY. Under the terms of this bill all the holders of stock in the future will have voting rights, if the bill is passed.

There are of course some difficulties about getting the names and properties of other types of security holders, such as debenture holders. It did not seem wise to carry it that far.

Under subsection (b) the comptroller or other principal accounting officer of an investment company is to be selected by the company's voting security holders or by the board of directors, but not by the president.

Under subsection (c) the commission is authorized to prescribe the minimum scope of the procedure to be followed in audits and to require accountants and auditors to keep accounts, reports, and work sheets, and so one, and have them available for inspection.

We have had some talk with representatives of accounting societies and, as I understand it, the one objection they make relates to subsection (c) of section 32. They have some difficulty with the proposal that the commission be authorized to prescribe the scope of procedure to be followed in audits. I am very hopeful that we can work out some substitute language for that.

The difficulty arises, according to my point of view, at least, from the fact that no two accountants ever seem to agree on what an audit is. Every one that you meet has a different definition of audit.

When I picked up the certificate that was made by the auditors and attached to the McKesson & Robbins statement, and held it up alongside of a copy of the engagement or contract between the McKesson & Robbins Co. and the auditors, taking that in one hand and their certificate in the other, I was extremely surprised. I did not see anything in the certificate that gave a security holder fair warning as to what things the auditor was responsible for and what things he was not responsible for.

It may be that there is some other way of approaching this. I despair of ever coming to an agreement as to a definition of audit. It may be that if the Commission is authorized to set some minimum standards, or if the Commission is authorized to require an auditor to disclose in some general way what he does or does not do, that will meet the problem.

If the committee is agreeable, we will continue our discussions with the accounting societies with the hope that we can bring back something that will be acceptable to them and to the proponents of this bill.

Senator HUGHES (presiding). We will take a recess at this time until 2:30 this afternoon.

(Whereupon, at 12:45 p. m., a recess was taken until 2:30 p. m., of the same day.)

AFTER RECESS

The subcommittee resumed at 3 p. m.

Senator WAGNER (chairman of the subcommittee). The subcommittee will resume. I have no doubt other members of the subcommittee will be here in a few minutes.

Mr. HEALY. Mr. Chairman, might I make a brief statement at this time?

Senator WAGNER. Yes.

ADDITIONAL STATEMENT OF ROBERT E. HEALY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. HEALY. Before Mr. Schenker resumes his discussion of the bill I would like to offer for the record a memorandum showing the cost of the study and a description of the work completed by the investment-trust study of the Commission. This is the expense item that Senator Townsend asked for a few days ago. If he or anyone else desires a further break-down of it we will be glad to get it.

In that connection I would like to say that each year, when the Commission has been before committees of Congress dealing with appropriations, the status of the investment-trust study has been reported, and each year additional funds have been appropriated by Congress for carrying on the investigation.

Senator WAGNER (chairman of the subcommittee). That will be made a part of the record at this point.

(The memorandum referred to, dated April 10, 1940, is made a part of the record, as follows:)

[Memorandum]

APRIL 10, 1940.

To: Senate Committee on Banking and Currency.
From: Securities and Exchange Commission.
Re: Cost of study and description of work completed by the Investment Trust Study.

I. Description of work completed by Study:
A. Public examinations:
250 companies subject of public examination.
33,000 pages of testimony taken in connection with public examinations.
4,800 exhibits introduced in connection with public examinations.
100 companies subject of field investigation.
B. Reports submitted to Congress:

Report	Date of transmittal	House Document No. and Congress	Approximate number of pages
Part one	June 10, 1938	707, 75th	160
Part two		70, 76th	940
Volume I (chs. I and II)	July 28, 1938		
Volume II (chs. III and IV)	Sept. 19, 1938		
Volume III (ch. V)	Oct. 31, 1938		
Volume IV (ch. VI)	Jan. 30, 1939		
Volume V (ch. VII)	Feb. 9, 1939		
Volume VI (ch. VIII)	Mar. 10, 1939		
Part three		279, 76th	3,000
Chapter I	Apr. 29, 1939		
Chapter II (first section)	do		
Chapter II (second section)	May 11, 1939		
Chapter II (third section)	June 14, 1939		
Chapter II (fourth section)	Aug. 7, 1939		
Chapter III	Oct. 10, 1939		
Chapter IV	Nov. 10, 1939		
Chapter V	Dec. 29, 1939		
Chapter VI (second and third sections)	Feb. 8, 1940		
Supplemental reports:			
Great Britain	June 26, 1939	380, 76th	75
Investment counsel	Aug. 17, 1939	477, 76th	70
Commingled funds	Aug. 30, 1939	476, 76th	50
Installment investment plans	Sept. 22, 1939	488, 76th	210
Fixed and semifixed investment trusts	Jan. 15, 1940	567, 76th	430
Face amount installment certificates [1]	Mar. 13, 1940	659, 76th	400

[1] Being printed at the U. S. Government Printing Office.

II. Cost of Study:

Fiscal year	Salaries	Number of employees	Travel	Witness fees	Reporting service	Total
1936	$68, 066. 23	58	$3, 443. 49			$71, 509. 72
1937	199, 152. 65	71	14, 261. 41	$3, 238. 67	$17, 419. 98	234, 072. 71
1938	112, 234. 60	35	10, 829. 50	2, 147. 60	2, 346. 99	127, 558. 69
1939	92, 227. 60	31	110. 25	697. 00	494. 28	93, 529. 13
1940 (to Apr. 1, 1940)	54, 612. 41	[1] 26				54, 612. 41
Total	526, 293. 49		28, 644. 65	6, 083. 27	20, 261. 25	581, 282. 66

[1] Includes 8 lawyers, 3 accountants, and balance includes statistical and stenographic staff.

Mr. Healy. Next, this morning when I was testifying I expressed the idea, possibly with some reservations, that the Federal Communications Commission had the same power, to approve or disapprove reorganizations in court which is given to the Interstate Commerce Commission under the Transportation Act, and given to the Securities and Exchange Commission under the Holding Company Act. I was mistaken. I understand they do not have any such power, although they are given power to appear and be heard in 77B or the Chandler Act cases as we should call them now, involving companies subject to their jurisdiction.

One other item: This bill does not have a provision covering the matter of notice and hearing in advance of orders to be issued by the Commission. That was not an oversight. It was omitted with the

deliberate intention of supplying it at a later date when the phraseology of it could be worked out in a satisfactory manner.

To be entirely frank about it, I think there is no harm in saying that one point as to which there was some doubt related to the question whether it was necessary to have notice and hearing in those instances where the decision was favorable to the applicant; or whether it should be merely confined to the cases where the question was open to doubt and there might be a difference of opinion as to what the result would be after hearing the parties.

Now, that provision will be compiled and submitted to the subcommittee.

Senator WAGNER. All right. Is that all, Judge Healy?

Mr. HEALY. Yes, Mr. Chairman.

Senator WAGNER (chairman of the subcommittee). You may proceed with your statement, Mr. Schenker.

STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, SECURITIES AND EXCHANGE COMMISSION, INVESTMENT TRUST STUDY, WASHINGTON, D. C.—Resumed

Mr. SCHENKER. Section 33 deals with settlement of civil actions in which investment companies are involved.

Senator WAGNER. What page of the bill are you on now?

Mr. SCHENKER. Page 74. During the course of our investigation we found that investment companies, for one reason or another, appeared to be particularly susceptible to representative stockholders, actions. Whether that is because of the nature of the activities of investment companies in that they may make investments and take losses and thereby may get disappointed stockholders, or whether it is attributable to the fact that there has been some prevalence of abuses in connection with that type of company, or whether misfeasance or nonfeasance is more prevalent in that institution, I would not attempt to say. I think the fact is that investment companies probably have been subjected to representative stockholder actions much more than industrial corporations, for instance.

Now, you have this problem: As Mr. Smith indicated, a management being in power and not wanting to have its activities aired in court, is in position to settle with the stockholder by buying his stock.

In a great many instances the investment company is really a nominal defendant because the officers and directors would not institute the action on behalf of the corporation. Under the rules of pleading and practice of many jurisdictions in such an instance the corporation has to be made a nominal defendant. You get the situation that in many cases the settlement is made, and instead of the officers and directors paying the settlement, or even the judgment, you may get the situation where the entire burden is borne by the investment company. The investment company may not have benefited from the misfeasance of the officers and directors; or even in the worst case, the officers or directors may have benefited from their wrongful conduct.

Senator WAGNER. Is that usually an action against the directors?

Mr. SCHENKER. It is usually a representative stockholders action. You may get a situation where one investment trust controls another and there is the claim that that investment company cleaned out the

controlling investment trust. The officers and directors of the investment trust are made party defendants.

Now, in such a situation the controlling investment company may be only a nominal defendant because the rules of practice require that it be made defendant where the officers and directors themselves refuse to institute the suit.

In that type of situation, although the persons who may have been guilty of the wrongful conduct, are the officers and directors—and in a more extreme case, they may have been the ones that benefited by their conduct—you may find that the damages, if any, are borne by the investment company.

Senator WAGNER. And there are some cases where, if prosecuted to the end, the corporations may not be found liable but the directors may.

Mr. SCHENKER. That is right.

Senator WAGNER. And in the settlement, of course, they absolve themselves in that way.

Mr. SCHENKER. Yes. That is the situation we are talking about. You may also get the situation, and I think there are cases like that, where there was a representative stockholder's action brought, and the investment company was not guilty of wrongful conduct but the officers and directors were. The case was settled, but instead of the officers and directors paying the settlement, they had the investment company settle it.

Fortunately in that case as I understand it the person who instituted the representative stockholders action was also a stockholder of the company which was being sued. Then he had to institute an action against the officers and directors for waste, for using the company's money to pay their own liability.

You also get cases, such as the extreme case of United Founders, where they pay a million dollars in settlement of a claim, and the only piece of paper that was served in that connection was a letter to the effect: Please take notice we have a claim against you. If you want to settle it we will be pleased to talk to you.

Well, the attorney had lunch with the officers of the company, and over the lunch table that case was settled for a million dollars without even the service of a summons or complaint.

Now, there the corporation itself is a fiction. If there was any wrongful conduct it must have been that of those persons who controlled the company. Yet the entire million dollars was paid by the investment company, and never at any time was there any disclosure in any report to stockholders, that a million dollars was paid in settlement of a claim which was asserted only in a written letter.

Now, what is the approach in this connection? We say in that type of case—a representative stockholder's action, or action predicated on wrongful conduct of officers and directors—that you cannot settle the case unless an action is instituted so that it is brought to the attention of a court.

Then we say—if it is in a Federal court—under the new Federal rules you cannot settle the representative stockholder's action unless the settlement is submitted for the approval of the court. And we say in that type of instance the Commission should be authorized merely to file an advisory opinion in connection with the settlement, so that the court may receive what assistance the Commission can give the court.

In that respect it is not unlike our approach in the Chandler Act cases, where we submit an advisory report, which the court may have and use.

I do not think I am disclosing any confidence when I say I happened to have lunch with the secretary of one of the judges who has been sitting in quite a few of these representative stockholder's actions, and he said he would feel this would be a great help. For instance, one may ask the court to approve a settlement of $1,250,000. The court does not know whether it is adequate or not, what the technical aspects of the transaction are which are involved, and so forth.

Senator WAGNER. I am only one member of the subcommittee, but I know that is very desirable.

Senator HERRING. That is what we have the courts for, to find these things out.

Senator WAGNER. I mean to have the aid of the Securities and Exchange Commission.

Senator HERRING. Certainly. A court ought to be given all the light possible.

Mr. SCHENKER. Now, in connection with the State courts—and of course the Federal jurisdiction does not apply there—we say if a State court asks us to submit a report and to give it what help we can, then the Commission is authorized to give the State court a report. That is, in the settlement of law suits.

Now, as to the remaining sections of the bill, I can run through a number of them quite hurriedly: Section 34, section 36, section 37, section 38, section 39, section 40, section 41, section 42, section 43, and section 44 are what we call boilerplate sections. They are really substantially the same provisions as are incorporated in our other securities and exchange acts. There may be some very minor changes, and if the subcommittee is interested I think we can submit a memorandum that will indicate what those slight changes are.

Senator HERRING. I am interested in section 28 dealing with face-amount certificate companies. We have them operating out in our State. You provide as I understand it for the deposit of certificates, or the assignment, or the placing of them, to cover face-amount certificates and their earnings.

Mr. SCHENKER. We provide that they have to maintain a reserve at a rate of 3½ percent which will enable them to meet their contract obligations when they mature.

Senator HERRING. And under our State law they must deposit them with the State. Now, of course, our State don't give up what it has, but you might stop them from further depositing them, and that in effect will stop them from doing business in our State.

Mr. SCHENKER. We were not unmindful of that situation. In almost all States or in a great many States, even if it is not required by statute, the securities commissioner may say: I will not let you sell your certificates here unless you have on deposit with me certain assets or mortgages or security that will insure payment of the certificates if anything happens.

Senator HERRING. That is what we have.

Mr. SCHENKER. That is an important subject and I will take it up in a minute. Unfortunately—and we have made a pretty detailed study of the company I have in mind, it is a big problem and is a big company.

Senator HERRING. Yes; and I take it you refer to the Minneapolis company.

Mr. SCHENKER. The Investors Syndicate, which we studied in detail. And we studied the Fidelity Investment Association of Wheeling, W. Va., in detail. We studied the United Securities Co. of Missouri in some detail. But particularly we studied the Investors Syndicate and the Fidelity Investment Association of Wheeling, W. Va., one having about 40 million dollars, and the other having many millions of dollars—

Senator HERRING (interposing). That is right, and it was a very important matter.

Mr. SCHENKER. Now, when we came to analyze the various agreements under which those securities were deposited with the various securities commissioners, although we had some of our best legal talent look at them, we could not really unequivocally say that such security, in the event the company went bankrupt, would be applicable to the certificate holder in the States which required security. There were certain Supreme Court cases which seemed to cast some doubt upon that fact. We asked them to submit a memorandum as to whether they would state unequivocally that all deposits made in a State would be applicable to the particular certificates sold in that State.

Senator HERRING. Well, we have possession of them and I would like to see them get them.

Mr. SCHENKER. Yes; of course you have possession of them. We used meticulous care to see that those States which have them can hold on to them. With respect to payments made on certificates already sold, you can keep those, too; but with respect to the future we provide differently.

Senator HERRING. I am interested in that.

Mr. SCHENKER. With respect to the future we think that this system should not be perpetuated, and for this reason: You may have an alert securities commissioner in your State and he may insist upon an ample deposit to cover your certificate holders. Then again, you can visualize a situation where there may be a securities commissioner who is not as alert. You might be surprised by the discrepancy that exists in the matter of deposit liability here and there. What we say as to the future is this: There should not be separate deposits, but if a company goes bankrupt then their certificate holders should share pari passu, and there should be no difference because a man lives on this side of the border of a State.

Senator HERRING. That may take place, but you cannot assume that the Federal authorities are any more competent than the State authorities. If you say that, then you may want to send everything down here to Washington.

Mr. SCHENKER. We are not unmindful of that, and we are not disparaging present deposits.

Senator HERRING. But your idea was that some insurance or securities commissioners are inefficient or incompetent.

Mr. SCHENKER. No; I did not say that.

Senator HERRING. You said that might occur.

Mr. SCHENKER. Oh, no.

Senator HERRING. That is a point we are somewhat touchy on.

Mr. SCHENKER. Oh, no; I did not mean that at all.

Mr. HEALY. I might explain that some States do not have those deposits at all. I think that when you are legislating for the United States you have to look to equal protection of all.

Senator HERRING. That is right.

Mr. HEALY. Without casting any reflection whatsoever on State commissioners, I think the fact that they are not all equally able——

Senator HERRING (interposing). That no doubt is true.

Mr. HEALY. There are inequalities among them; and some of them do not have the power under their own State laws that some other commissioners are given. Now, as Mr. Schenker points out, the existing status is not disturbed so far as the deposits are concerned. But I think a study will show that there are several States where the deposits are not large enough to cover the complete obligation that may later inure to the benefit of the citizens of those States.

Senator HERRING. Then the officers are derelict. We assume we are up to date.

Mr. HEALY. They may be going as far as their State law permits them to go. I am not blaming your State, Senator Herring.

Senator WAGNER. And you, Governor Herring, appointed them there and ought to know about them.

Senator HERRING. Yes; and I think I do.

Mr. SCHENKER. Does that answer that question?

Senator HERRING. Yes.

Senator WAGNER. You may now proceed, Mr. Schenker.

Mr. SCHENKER. I skipped one section of the bill, and that is section 35, which deals with unlawful representations and names. Subsection (a) is the provision which says that it shall be unlawful for a person to represent, just because he is registered under this act, that the company, or its securities, has been recommended or approved by the United States or any agency or officer thereof.

Then subsection (b) says it shall be unlawful for any person to make a similar representation about himself. In other words, subsection (a) really deals with securities, that one cannot make a misrepresentation with reference to securities. Subsection (b) says one cannot make such a misrepresentation with respect to a person; and then subsection (c) says subsections (a) and (b) do not prevent one from saying "I am registered under this act" if such statement is true in fact, provided he does not do that by saying or implying: By virtue of that registration the S. E. C. has passed upon the soundness of the security.

Subsection (d) is a provision which makes it unlawful to use any name that might be misleading, such as United States income fund, or New York income fund, or guaranteed dividends which will take care of your old age and your wife and your boy's college education. It is just the same thing as that there should not be some bank known as the Bank of the United States. That is what this subsection (d) is.

Senator HERRING. Section 36 of the bill, subsection (a) provides—

> The Commission shall have authority from time to time to make, issue, amend and rescind such rules and regulations and such orders as it finds necessary or appropriate to carry out the provisions of this title.

It seems to me that is a pretty wide discretion, particularly when you provide a penalty for violating rules which you may make or amend.

Mr. SCHENKER. I think Judge Healy would like to be heard on that.

Mr. HEALY. This is substantially the same provision that has been inserted in each one of our acts, and it was just carried over. In my opening statement, at the very beginning of these hearings, I made reference to this matter. I do not remember whether you were here then or not?

Senator HERRING. I am sorry but I was not present at the time.

Mr. HEALY. If you would like, I will be glad to read that. It is very short.

Senator HERRING. No; if it is in the record I will read it there.

Mr. HEALY. I do not feel that I could add much to what I said on that point.

Senator HERRING. You do not think it would be granting too great discretion to the Commission?

Mr. HEALY. I do not. I think that the argument, from my angle at least, is not in favor of obtaining power for the body of which I happen to be a member but is in favor of flexibility. You will find many situations where you can write a statutory standard without harming anybody. Then you find other situations where a strict statutory standard, with no rubber in it, will deal fairly with 90 percent of the cases and work an injustice in 10 percent. It seems to me it is very desirable that you make some provision for the unforeseeable and unpredictable instance that comes along that nobody can anticipate.

Senator HERRING. All right.

Mr. HEALY. However, as I set out in my statement, if the subcommittee feels that anything that is left to the Commission to administer is not accompanied by an adequate, a definite standard, we certainly will not make the slightest objection to having our administrative burden lightened.

I would like to say again what I said the other day: that I think any statute that permits the application of unlimited or unfettered discretion is unthinkable. I am a firm believer in the doctrine that ours is a Government of laws, and I have said it very emphatically before now, and in places where it did some good. My brother commissioners, I am sure, share this view. I can produce a document I filed with the fifth circuit if you would care to see it, in a certain case.

Now, I do not think you offend that principle when you say that the Commission shall make rules to accomplish the following; or when you set up a standard and give it to the Commission to administer. Of course if the subcommittee thinks otherwise, then they should write the bill the other way.

I would like to add this thought: I do not personally happen to believe that the administrative process can survive, or ought to survive, unless it can fit in with the American ideal of the supremacy of law. We do not have the power to make laws. Nobody has that power except the Congress. The Congress cannot delegate it to us or to anybody else. The *Schechter case* reminded us of that very forcibly. But you can write a law and then give us power to implement it or to fill in the blank spaces the Congress has to leave.

Senator HERRING. You think a saving qualification is appropriate in order to carry out the provisions of this title.

Mr. HEALY. It seems so to me. But if the subcommittee feels it should be further restricted, and it can be done without robbing its administration of its flexibility, I shall offer no argument against it.

Senator WAGNER. Right there let me ask you this question: If such a flexible provision were not in the act and let us suppose the Commission makes a definite rule to carry out the provisions of the act, on a definite standard, and you yourselves find that the rule you have adopted, because of a change in conditions or something or other, is a very unfair rule, where would you be? Well, there you are, with a fixed rule and with no authority here to rescind it. What would happen in a case like that?

Mr. HEALY. Well, if we did not have authority to rescind it I think we and the people affected by the rule would be in a very unpleasant predicament. But if we should adopt a rule of that sort I should think it would be our duty to rescind it immediately.

Senator HERRING. Perhaps there might be quite a bit more care used in adopting a rule in the first place in those circumstances.

Mr. HEALY. Let me say this: that if we were to adopt a rule, and if a person is affected by that rule and there is an actual, judiciable controversy between him and the Commission, he could get a court review, could get a court decision on the subject of the validity of our rule.

Further than that, while I of course will not vote for any rule in the Commission that I do not think is authorized by the statute, yet if a litigant comes before the Commission and shows me we have adopted a rule that is outside of our powers, or even a rule that is inside our powers but is unwise, I shall not hesitate to vote to abrogate it. And my pride will not be hurt the least bit in doing it.

Senator WAGNER. The point I tried to make, Judge Healy, although I may not have made it clear, was that the mere fact of the power being given to you to make rules and regulations implies the power to rescind or modify them. I was wondering why this provision is necessary at all.

Mr. HEALY. Well, the question is——.

Senator WAGNER (continuing). You are a lawyer and so is Mr. Schenker, and all your distinguished attorneys ought to be able to enlighten us on that point.

Senator HERRING. I am the only one here who has no curse on him. [Laughter.]

Mr. HEALY. Well, of course we do not have the power to make rules unless the Congress gives it to us.

Senator WAGNER. I mean if given the power to make these rules and regulations, and if there is nothing further said in this bill, does it not imply that you have the power to modify or to amend those rules at any time?

Mr. HEALY. Yes, sir; I should think so.

Senator WAGNER. So that even if this provision were not in here I should think you would have that power.

Mr. HEALY. The implied power?

Senator WAGNER. Yes.

Mr. SCHENKER. But this provision deals with another aspect of the subject because it says:

> The Commission shall have authority from time to time to make, issue, amend, and rescind—

Now, that means to amend, rescind, or abrogate what?

> such rules and regulations and such orders as it finds necessary or appropriate to carry out the provisions of this title, including rules and regulations defining accounting, technical, and trade terms used in this title—

If we had to define every technical trade term, in the statute, you can see what the size of this bill would be. All it says in connection with the accounting section is that we can make rules and regulations "defining accounting, technical, and trade terms used in this title." And similarly we make provision that we are to make rules in respect of classification of investment companies.

Senator WAGNER. I see that, but I still contend that being given the power to make rules and regulations in reference to all these provisions, that in itself implies the right to change or modify or rescind these rules at any time, does it not?

Mr. HEALY. Obviously, yes. I would say there is no doubt about it to my mind.

Senator HERRING. Does not that also almost have the dignity of letting you apply section 43 of the bill, which provides for a fine of not more than $10,000 or imprisonment for not more than 2 years, or both, in case of the violation of any rule which the Commission has adopted?

Mr. HEALY. May I say in that connection that as I read this thing it does not give us substantive powers. We cannot make any new law under this. We can only implement the laws the Congress has made. We can write rules, say, on practice and procedure. We can define accounting, technical, and trade terms. We can classify them, and things of that sort. I am sure it does not give us the least power to impose any additional requirements on anybody that this law itself does not impose.

Senator HERRING. Then it is merely a regulation to implement what the law says.

Mr. HEALY. That is my view of it. And if this language is not appropriate to accomplish that result it ought to be revised.

Senator HERRING. I would not say that you are wrong, Mr. Chairman, but you see what I mean.

Senator WAGNER. I do.

Mr. HEALY. I think it is a very important question, and the Commission is most anxious, as the subcommittee is, that it be solved properly.

Senator WAGNER. Of course, I suppose this is the time to suggest questions that trouble you somewhat, Senator. When these rules are promulgated, they have the effect of statutes.

Senator HERRING. Yes.

Mr. HEALY. May I interpose something there?

Senator WAGNER. Yes.

Mr. HEALY. I think that under the decisions of the courts there are at least two classes of rules of administrative bodies. There are rules implementing statutes, the violation of which may be punishable.

Senator WAGNER. Yes.

Mr. HEALY. There are other rules that do not fall into that category, which are simply interpretative rules. For example, nobody could be put in jail because he disagreed with our definition of a technical or trade term.

Senator WAGNER. That is the very question I was coming to; that is what is troubling me.

Mr. HEALY. Our interpretative rule stating that in our opinion a certain phrase means a certain thing is just as much subject to review by a court as a formal decision with an opinion behind it, when there is a controversy that is judiciable in the courts.

Senator WAGNER. Judge Healy, I was wondering if there could not be a segregation. I do not know. In the case of a rule in which you prescribed a certain method of accounting, you would not want to make a violation of that rule to be punishable by a $10,000 fine or by 3 years imprisonment?

Mr. HEALY. I am afraid I have to say I think I would.

Senator WAGNER. You would?

Mr. HEALY. I would think that under those circumstances the extreme penalty would be absurd and completely out of line. However, if Congress gives us the power to prescribe accounting regulations, then those regulations must be enforceable.

Senator WAGNER. Well, you may be right about that. I am just raising the question.

Mr. HEALY. Improper accounting has had some very disastrous consequences for investors—extremely disastrous. I think that proper accounting, not only in this field but in every other field, is extremely important. We have some instances of very bad accounting in some of these companies.

If you do not want to allow us to prescribe accounting regulations and then make them enforceable, then I see no alternative but for Congress to prescribe the accounting regulations itself.

Senator WAGNER. I did not go so far as to say that. I was wondering whether making that a felony is rather severe.

Mr. HEALY. Yes.

Senator WAGNER. It may not be enforceable, for that reason.

Mr. HEALY. Well, perhaps the proper method of handling that would be to make the accounting regulations enforceable by mandamus or appropriate administrative action, without making it subject to a criminal penalty. I have not thought that through.

Senator WAGNER. Well, you may be right. It may be that it is sufficiently important so that its violation should be as prescribed here.

But offhand it did seem to be a severe penalty for that violation. Now, I bow to your superior judgment in these questions.

Mr. HEALY. I state for the record that the Securities and Exchange Commission has never recommended the prosecution of anybody for inadvertent or unintentional violation of a statute.

Senator WAGNER. Well, I am not concerned that wisdom will not be exercised in its enforcement.

Senator HERRING. Speaking of accounting, it seems to me that you provide here a system of accounting and then forbid the keeping of any other record. What is that?

Mr. HEALY. It does not go quite that far.

Senator HERRING. I thought I read something like that. I wonder why you prohibit the keeping of any other records.

Mr. HEALY. If you will look at page 72, subsection (f) in section 31, you will see we expressly say they may subclassify accounts and maintain supplementary records in any manner which does not impair the integrity of the accounts.

Senator HERRING. Oh, yes.

Mr. HEALY. I think that is a rather necessary provision. As I can show you—not in the investment trust field, but I can show you in the case of the New York State subsidiaries of the Associated Gas & Electric Co.—we do find this kind of a situation: Under the

State laws they were forbidden to make certain types of entries on their books, to wit, write-ups or mark-ups of their property account. So they told the State commission that they did not make them. They did not report them to the State commission; but they kept a supplementary account in which they recorded the write-ups and mark-ups; and for several years the published reports to their stockholders included the write-ups. In other words, they were not in accord with the accounts which they reported to the Public Service Commission of the State of New York.

Now, Senator, I would agree with you if you were to say that you do not want to put accounting in a strait jacket. On the other hand, I think that if you are to preserve the integrity of accounting, you have got to have some authority about it and you have got to circumscribe it somewhat.

Senator HERRING. I did not know just the meaning of that. It appeared to forbid the keeping of any records which they might want to keep for their own convenience or use, which would have no effect on the record which you direct them to keep and which they must keep, of course.

Mr. HEALY. I should think that they should be allowed to keep any record that they pleased, that did not destroy the integrity of the accounting that was prescribed under the classification.

Senator HERRING. Yes; that is all right.

Senator HUGHES. But they would go beyond that, would they not?

Mr. HEALY. I beg your pardon?

Senator HUGHES. They would keep these supplementary accounts and, as I understand it, they would make the practice of sending them out to their stockholders; so they had the account you required and they had another account, and the facts in that they gave to their stockholders?

Mr. HEALY. That is true.

Senator HUGHES. I should think that would be misleading and very confusing and dangerous.

Mr. HEALY. Please notice I said to the Senator that I did not oppose records which did not destroy the integrity of the other record. Furthermore, as was stated this morning, we have discovered quite a number of instances—I question whether any of them are in the investment trust field; I do not remember it. However, there is in existence in the Commission a memorandum where there is pointed out the variances and discrepancies between the accounts and financial statements filed with us, under our acts, and the accounts and financial statements reported by the same corporations to their stockholders.

Now, Senator, there is a provision in this bill where that sort of thing can be corrected.

Senator HUGHES. Where is that? Is that destroying the integrity of your account?

Mr. HEALY. I think that is designed to preserve the integrity of the accounting. It is designed to see that the sworn accounts filed with the Government and maintained on their books are reported to the stockholders in that form and not in some other.

Senator HUGHES. Yes, that is what I have in mind.

Mr. HEALY. If the Senator will look at page 68, at subdivision (c) of section 30——

Senator HUGHES. Subdivision (c)?

Mr. HEALY. Yes, sir.

Senator HUGHES. Yes. Yes, I see it. That is power enough to control it, I think.

Mr. SCHENKER. I beg you pardon, Senator?

Senator HUGHES. I say I think that is power enough to control it.

Mr. HEALY. I beg your pardon, sir?

Senator HUGHES. I say that is power enough to control it.

Mr. HEALY. Yes; I should think so.

Mr. SCHENKER. Are you through, Judge Healy?

Mr. HEALY. Shall we go on to something else, or is there another point?

Senator WAGNER. Very well.

Mr. SCHENKER. Section 45 contains the general provisions and definitions, and section 46 is the separability of provisions.

Section 47 says that "this title may be cited as the 'Investment Company Act of 1940.'"

Section 48 is with respect to the effective date of the act and states that the "effective date of this title is October 1, 1940. Except where specific provision is made to the contrary, every provision of this title shall take effect on said effective date."

Then we come to title II, which deals with investment advisers.

Section 201 specifies the findings; section 202 specifies the policy; and section 203 incorporates by reference certain provisions of title I, with respect to definitions, and so forth. Now, Senator, there is a typographical error in section 203, and we should like to correct it on the record. It should read, after the colon, as follows—

> Sections 3, 34 (b), 35 (b) and (c), 36, 37—

And "(e) and (f)" should be stricken out—

> 38, 39, 40, 41, 42—

Here "43" should be stricken out and replaced with—

> 44, 45, and 46.

And "47" should be stricken out.

Section 204 says that it is unlawful for a person engaged in the investment advisory business to use the mails or instrumentalities of interstate commerce unless he is registered under this section.

Then subsection (b) makes provision for an exemption which is quite tight. It says it shall not apply to investment counselors whose clients reside within one State and do not give advice with respect to securities which are dealt in on a national securities exchange or which are dealt in in interstate, over-the-counter markets. I think we have about got everybody who is in the investment counselor business.

Subsection (c) sets forth the mechanics for registration and sets forth the information which will be required by this simple registration statement.

Now, Senator, the people in the investment counselor profession may have some difficulties with the phraseology here. We are still talking to them. I think they do not disagree with the substance of the provisions.

What do we ask? We ask about their organization and personnel, including the number of employees; we ask about their education and experience and background and their past and present business affiliations. We ask the nature and scope of their business and what kind

of advice they give. Then we ask what kind of authority do they have over their clients' accounts; is it discretionary authority or do they just give advice. We ask what is the basis of his compensation, and then we ask for copies of the regular type of contract that he uses. Then we have here a provision:

such further information and copies of such further documents relating to such investment adviser, his or its affiliated persons and employees as the Commission may by rules and regulations or order prescribe as necessary or appropriate in the public interest or for the protection of investors.

That provision is not unlike the one that Judge Healy discussed in connection with the registration of the companies, and is not unlike the provision in section 15 (b) in the Securities Exchange Act of 1934 which relates to the registration of over-the-counter brokers and dealers.

The mechanics are that they file the application, and it automatically becomes effective. Then if the person is the type of individual set forth in subsection (d), the Commission can revoke or deny his registration. The mechanics is something like a compulsory census of the industry: "You tell us who you are." Then, if he discloses in his application or if we ascertain from independent sources that he has had a jail record in connection with a securities fraud or has been subject to an injunction in connection with a securities fraud, we can revoke his registration.

The other provision is that we can deny him registration if he has not filled out his application correctly or has told an untruth. You have to make provision for that; otherwise he will just fill in his name and file it. Then it becomes effective and we cannot hold up the registration.

Mr. Healy. May I say that the effective purpose—whether this is the appropriate means to accomplish it or not—the real intent of this is to see to it that men with this kind of a record cannot go into the business of being investment advisers.

Then again comes this question of rubber and flexibility; because there will be cases where people have been convicted within 10 years, where the circumstances may be such that, nevertheless, it might be proper to allow them to go back into that business.

Mr. Schenker. The commencement of a proceeding to deny registration acts to postpone the effective date of registration; but you notice there is no provision that the institution of a proceeding to revoke or suspend his registration acts as a stay in his business.

Do you see what I mean?

Senator Wagner. Yes.

Mr. Schenker. So that he can keep doing his business until the proceeding has been determined.

Then (f) is that if he ceases being an investment counselor, provision is made for the cancelation of his registration.

Section 205 is the provision which is aimed at the method of compensation. As I recall it, it was virtually the unanimous consensus of the 324 people whom we studied, with 1 possible exception, some individual in California, the unanimous consensus of the industry that what you ought to abolish is these profit-sharing abuses in the industry: "If you make any money, you turn part of it over to me; but if you lose, I don't lose anything."

It is one of those "Heads I win and tails you lose" propositions. He does not participate in the losses, but participates only in the profits. That is one of the provisions we put in the sections relating to the management of investment companies. That is to eliminate this profit-sharing method of compensation.

Section 206 is just a broad section which says you shall not do anything to defraud your client, or do anything which operates as a fraud on your client. The investment adviser cannot sell, to his client, any property or securities as principal, with this exception: Under section 15 of the 1934 act the National Association of Security Dealers was formed; and out of the 6,000 people who registered with the Commission as brokers and dealers, I think 2,500 or 3,000, over 2,800 have become members of this voluntary association which has undertaken to police itself.

We have said that a person who is a member of that association, since he is subject to the supervision of that association, may deal with the client, provided he discloses to the client that he is selling securities to the client, as principal.

Mr. Healy. May I interrupt for just a moment?

This association is formed under the so-called Maloney Act—is the National Association of Security Dealers; I want to express the view that they have made a magnificent start and that there is every indication that they are going to do a first-class job. I say that because I do not want something else that I am going to say to be misinterpreted.

Let me also say that the investment adviser in the instance covered by the bill is principal and agent; and I suppose the argument in support of this provision is that when he acts as principal instead of agent and sells to his own client, you can permit that only if he is under the surveillance and control of that National Association of Security Dealers.

On the other hand, I personally have a little difficulty with this section; because granted that everything that I have said in favor of the Maloney Act association is true, I still have some difficulty with the idea that the right of a man or a citizen to do a certain kind of business in the United States depends upon whether or not be belongs to a certain association, however worthy.

Now, Senator, I think that fairly states the two points of view on that suggestion.

Senator Wagner. Yes.

Mr. Schenker. If the committee should feel that Judge Healy's analysis of the situation is correct, then I think it is the Commission's recommendation that all self-dealing between the investment counselor and the client should be stopped. The investment counselor should not be able to sell his client any securities as principal.

The last paragraph—paragraph (4)—of that section I have described; that is no use in repeating that or in reverting to it.

Section 207 is the penalty section.

Section 208 is the short-title section.

Section 209 is the effective-date section.

Now, Senator, we should like to introduce into the record——

Senator Hughes. Do I understand you have two views of whether he should sell to the customer?

Mr. SCHENKER. The Commission, after discussing this problem—and I think this is an accurate recapitulation; and if I am wrong, Judge Healy can correct me—the feeling of the majority of the Commission is that if he is a member of the association, then he should be permitted to sell securities as principal to the account—to the client—provided he is a member of the association and makes the proper disclosure.

Senator HUGHES. The Maloney Association does not embrace all of them in that business? That is voluntary?

Mr. SCHENKER. It is the voluntary association.

Senator HUGHES. Those on the outside cannot do this?

Mr. SCHENKER. No; the outsiders cannot do this. What Judge Healy feels a little uncomfortable about is, Why should discrimination be made? Why should the person on the outside not have that right, while the person who is in the association has that right?

Senator HUGHES. As far as I am personally concerned, without giving it any great consideration, I think there is danger in that.

Senator WAGNER. What is that?

Senator HUGHES. I think there is danger in allowing them the right to sell, and in not allowing that right to the others.

Senator WAGNER. Not allowing that right to the others—those outside of the organization?

Senator HUGHES. Yes.

Senator WAGNER. That is what appeals to me, too; I was going to raise that question myself.

Mr. HEALY. I should like to say, however, that I did not have an opportunity to discuss this section with the other members.

Senator WAGNER. You think it is all right, do you?

Mr. HEALY. They have never heard my views on this point; I happened to be away.

Senator HUGHES. I think it is a matter to which you should give some thought.

Senator WAGNER. I suppose that the distinction in that case is that they belong to an association which scrutinizes all their activities but, nevertheless, it is voluntary.

It is not scrutinized by the Securities and Exchange Commission, is it?

Mr. SCHENKER. They have to comply with certain requirements, in order to belong to the association.

Senator WAGNER. Yes.

Mr. SCHENKER. On that matter I talked to the investment bankers who also act as investment counselors, and who are affected by this provision. We had a conference and spent a whole Saturday with them. Ordinarily they would not dream of taking any inventory of securities they have on their shelf and selling them to their clients.

Senator WAGNER. Yes.

Mr. SCHENKER. They do not want that right, really, although this provision may give them this right.

The situation which they feel ought to be excluded is where they are underwriters of securities, where their client can get a little cheaper price, and their client insists, "Why should I be penalized and have to pay a little more for my security just because you happen to be my investment counselor?"

And that is true of municipals and so forth.

I do not know what great harm would result if the provision were made applicable to everybody. However, they submitted this to the Commission, and we incorporated it in that respect.

On the other hand, if a fellow feels he has a sour issue and finds a client to whom he can sell it, then that is not right, whether it is done by a member of the association or a person who is not a member of the association.

May I go on, Senator?

Senator WAGNER. Certainly.

Mr. SCHENKER. What we should like to do is to introduce into the record a recapitulation of the testimony of all the witnesses who appeared at our public examinations, who expressed their thoughts with respect to our recommendations. During the course of the public examinations that we held—and we held public examinations on 250 investment trusts, representing probably 95 percent of the total assets of the industry—we would ask, "What do you think of complex capital structures?" "Don't you think they should have one class of stock?" "Should investment trusts borrow?"

What we have done is to take the precise question and the answer verbatim and key it into the section of the bill to which it is applicable.

I should like this to be made clear: That we have culled out only those portions of the record which sustain the recommendation. I also want to qualify it further: We have culled out portions of the testimony which sustain the recommendations, and have not included portions of the testimony which may have been against other recommendations.

For instance, a person says, "Yes; I think there should be one class of stock in investment companies."

We asked them, "Should they borrow?"

They say, "Yes; they should be able to borrow"—although the Commission has ultimately recommended that there be no borrowings.

Senator WAGNER. Whose answers are those?

Mr. SCHENKER. Those are answers of the investment company witnesses.

Senator HUGHES. Are they now available?

Mr. SCHENKER. Some of them will be here. However, in order to make a complete record as to the members of the industry who have expressed their opinion in favor of the particular recommendations we have culled those out. If the committee wants us to get a compilation of the expressions of opinion against the recommendations, we shall be pleased to do that.

Senator HUGHES. I presume we shall get that when those witnesses come.

Mr. HEALY. I am not completely clear in my own mind whether we should offer this compilation at this time.

Senator WAGNER. We are going to hear the industry.

Mr. HEALY. Yes; you are going to hear them.

Senator HUGHES. It might be well to hold that until after you have found out who does come and what they do say. Then introduce it for those who do not come here and state their views.

Mr. SCHENKER. The only thing is that these ideas are not novel; they have been discussed with a great many people, and a great many

people found some sense in them. We are not saying that everybody who appeared was for us.

Senator HUGHES. I see no objection to using that at the end, after we have heard the other witnesses.

Senator WAGNER. Why not hold that until the end?

Mr. SCHENKER. I beg your pardon?

Senator WAGNER. Do you want to offer it, or hold it until a later date? What is the final judgment about it?

Mr. HEALY. My judgment, in view of the suggestions made here, is to hold it until a later time, and not to offer it at this time.

Senator WAGNER. Very well.

Mr. SCHENKER. I think that completes our presentation.

Mr. HEALY. I suppose it is understood that we can be heard at a later time, if desired?

Senator WAGNER (chairman of the subcommittee). Oh, yes; we do not conduct this in an inflexible manner. What the committee seeks is information.

Senator HUGHES. We probably shall want to hear them again.

Senator WAGNER. Yes.

Mr. HEALY. We shortened our presentation at the suggestion of the chairman.

Senator WAGNER. Yes; I might say that Judge Healy had a number of other examples to give us; but I thought that for the present the committee had sufficient, at least, upon which to hear the other side.

Senator HUGHES. We have had a good many.

Senator WAGNER (chairman of the subcommittee). We have finished with you?

Then who is to speak for the other side?

Mr. BUNKER. I am to speak; my name is Bunker.

Senator WAGNER. I suggest that we go on on Friday morning; that will give you all day tomorrow to prepare your presentation.

Mr. BUNKER. Yes; Mr. Chairman. Of course, we do not want to hold things up.

Senator WAGNER. Yes; I know that you do not want to do that.

Very well. You are going to open the presentation, Mr. Bunker? Will you be the first witness?

Mr. BUNKER. Yes; the first witness.

Senator WAGNER. Very well. Of course, we cannot regulate the time, because we do not know just how late we shall sit or how long you will take. We are not going to limit anybody.

Mr. BUNKER. Do you want some more names?

Senator WAGNER. We have here Mr. Bellamy, Mr. Quinn, and Mr. Bunker.

Mr. BUNKER. And then we can reappear?

Senator WAGNER. Oh, yes; we shall not be rigid about it. The only thing is that you should avoid, I think, any cumulative matter.

Mr. BUNKER. Of course.

Senator WAGNER (chairman of the subcommittee). Yes; we shall not have any difficulty about that; this is no court.

Very well; then the committee will meet on Friday morning at 10:30. Mr. Bunker will be the first witness.

(Thereupon, at 4:05 p. m., a recess was taken until Friday, April 12, 1940, at 10:30 a. m.)

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